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Before the

UNITED STATES COPYRIGHT ROYALTY BOARD

Library of Congress

Washington, D.C.

ORIGINAL

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In Re:                          : Docket No.
                                : 15-CRB-0001-WR
Determination of Royalty        : (2016-2020)
Rates and Terms for             :
Ephemeral Recording and         : Volume 22
Digital Performance of          : Pages 5950 - 6253
Sound Recordings (Web IV)       :
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RESTRICTED MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER

DAY 22

Washington, D.C.

Wednesday, May 27, 2015

The hearing in the above-entitled

matter was convened at 9:10 a.m.

BEFORE COPYRIGHT ROYALTY JUDGES:

SUZANNE M. BARNETT, CHIEF JUDGE

DAVID R. STRICKLER, JUDGE

JESSE FEDER, JUDGE

5951

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 8  ERIC L. TALLEY, PH.D.

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1   P R O C E E D I N G S

2   (PUBLIC SESSION)

3   CHIEF JUDGE BARNETT: Good morning.

4   Please be seated.

5   We have held you in suspense for long

6   enough. So this morning, Judge Strickler will

7   deliver the ruling with regard to the Danaher

8   testimony, and Judge Feder will deliver the ruling

9   with regard to the after payments.

10   JUDGE STRICKLER: Good morning.

11   IHeart had moved to exclude from

12   evidence Professor Danaher's written expert

13   testimony that had been withdrawn, and iHeart's

14   motion to exclude is granted. This is an expert

15   witness who was withdrawn. The briefs demonstrate

16   that the authority is split with regard to whether

17   or not such testimony can be admitted.

18   On balance, we find the authority is

19   better to construe such a witness as a consulting

20   witness rather than as a testifying witness, and,

21   in addition, the data that was underlying that

22   testimony has been utilized and examined by other

23   witnesses and there has been cross-examination and

24   the opportunity for cross-examination to cover the

25   underlying substance of what was covered by

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1 Professor Danaher. So for those reasons, his

2 written testimony is excluded.

3   JUDGE FEDER: Regarding SoundExchange's

4 request to permit witnesses from Sony and Warner

5 to address preexecution projection models that the

6 labels created in approving the Apple iTunes Radio

7 agreements and regarding amendments to the cloud

8 service agreements, that motion is also denied.

9 We view this as new data and new analysis, and, in

10 accordance with our prior rulings on that subject,

11 we will not permit that.

12   CHIEF JUDGE BARNETT: Cross-examination

13 for Professor Blackburn at this point, or

14 Dr. Blackburn?

15   MR. MILLER: Yes, Your Honor. And a

16 couple of housekeeping matters.

17   You have, of course, binders in front of

18 you. It wouldn't be a day at the CRB without

19 them.

20   I did inform counsel, I think, that

21 we'll have to begin this session in restricted,

22 but I imagine that will be fairly limited, and

23 then we can move into unrestricted for the

24 balance.

25   CHIEF JUDGE BARNETT: Okay. So we're

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1 going to begin the morning by kicking you out if

2 you have not signed the nondisclosure agreement.

3   (THIS ENDS PUBLIC SESSION)

4   (RESTRICTED SESSION BOUND SEPARATELY)

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11   (END OF RESTRICTED SESSION)

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1   (THIS BEGINS PUBLIC SESSION)

2   BY MR. MILLER:

3   Q   In section 5 of your written rebuttal

4   testimony, you opine that interactive and

5   noninteractive services have the same

6   promotional/substitutional impact on the industry?

7   A   Yes, I think that's right, that's

8   what -- the data suggests that there's no

9   identifiable difference.

10   Q   If I could ask you to turn to paragraph

11   42 on SX 24-028.

12   A   Okay.

13   Q   Are you with me?

14   A   I am.

15   Q   In reference here to the table 2 above,

16   you say that the column B here shows the average

17   change in the number of tracks purchased by users

18   who adopt a streaming service in the second

19   period, and it goes on from there to say is not

20   significantly different from zero. Do you see

21   that?

22   A   I do.

23   Q   From a statistical perspective, the best

24   estimate you have of the effect on song downloads

25   being a noninteractive value is the point estimate

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1   here in table 2, right?

2   A   Yes. I mean, I guess if you put a gun

3   to my head and said you have to pick a number,

4   that's the best estimate, but I think the

5   statistical testing suggests that you shouldn't

6   believe very strongly in that number as opposed

7   to -- as opposed to zero, for example.

8   MR. MILLER: If we could pull up the

9   table 2 on the screen. We may try to blow this up

10   a little.

11   Q   Yesterday you showed part of it. You

12   showed the column C in the demonstrative. But

13   this is the full table, correct?

14   A   That's correct.

15   Q   You would agree that the point estimate

16   in your table 2 analysis for the noninteractive

17   users in period 2, in column B, is positive.

18   Steve, can you make sure we show them

19   what column B is here. There we go.

20   So the point estimate in column B for

21   the noninteractive users is positive, correct?

22   A   I agree that's a positive number. I

23   don't agree it's right to look at column B instead

24   of column C.

25   Q   We'll talk about B, and then I'll have

1 questions about C as well.

2   A   It is a positive number.

3   Q   Specifically, the average change

4 presented in column B -- we may need to highlight

5 this, Steve -- in the number of tracks purchased

6 by noninteractive users who adopt a streaming

7 service in the second period is 5.123?

8   A   Or that's if you -- if you restrict the

9 analysis only to people who actually purchase

10 music after they started adopting, that's correct.

11   Q   So for that group of users, that means,

12 according to your analysis, that those

13 noninteractive users presented in column B, on

14 average, purchased 5.123 more downloads -- more

15 song downloads in period 2; is that correct?

16   A   That's the interpretation, yes.

17   Q   And period 2, just for clarity, is the

18 three-month period after which a user started

19 using a noninteractive streaming service like

20 Pandora or iHeart, correct?

21   A   So I think it's the three -- it's the

22 second three months of the data set. At some

23 point during those three months they started

24 using.

25   Q   So just to be clear, according to your

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1   analysis, a noninteractive user presented in

2   column B, on average, purchased approximately five

3   more song downloads during the three-month period

4   after which the user started using a streaming

5   service like Pandora or iHeart?

6   A   So that's not strictly correct. That's

7   among -- that's only looking at the subset of

8   users who purchased music at some point, and as I

9   note in my written testimony here, that's an

10   inappropriate restriction that I did only to be

11   consistent with what Professor Danaher did, and it

12   suffers from the same flaws that excluding the

13   zero sales that Dr. McBride did does. And you can

14   see in column C that when you actually account for

15   the people who aren't affected, which is

16   important, the average effect is a much smaller

17   number, yet still statistically indistinguishable

18   from zero.

19   Q   But still positive.

20   A   It is a positive number, that is

21   correct.

22   Q   By contrast, the point estimate in your

23   table 2 analysis on an interactive user in

24   period 2 in column B -- column B for now -- is

25   negative, right? It's a negative 3.383?

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1   A   I mean, again, it's a negative number.

2   If the question is, does it have a minus sign in

3   front of it, it does.

4   Q   Right.

5   So the average change in the number of

6   tracks purchased by an interactive user who

7   adopted a streaming service in the second period

8   is negative 3.383, correct?

9   A   Again, restricting it inappropriately

10 only to the people who actually purchase music and

11 ignoring all the people who are not affected, you

12 get negative 3.383.

13   JUDGE STRICKLER: If we look at your

14 column C, which includes those who were not

15 affected at all --

16   THE WITNESS: Yes, sir.

17   JUDGE STRICKLER: -- so you have for the

18 noninteractive user, period 2, .624 --

19   THE WITNESS: Yes.

20   JUDGE STRICKLER: -- for the three-month

21 period, and for the interactive users, .493,

22 right?

23   THE WITNESS: That's correct.

24   JUDGE STRICKLER: So does that

25 demonstrate a promotional effect for

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1   noninteractive users relative to interactive users

2   but very, very mild, on the order of, net, about

3   one every three months?

4   THE WITNESS: So I talked about this a

5   little bit yesterday. So that's the point

6   estimate that you get, but the standard error is

7   sufficiently high on that, that the p-value is

8   like .35, so it's something that -- you know,

9   without going into all the details of hypothesis

10 testing and teaching a statistics class, what that

11 means is if it were true that there were no

12 difference, you would see something like that. If

13 it was true that there was actually no difference,

14 right, we could set up a world where we knew for

15 certainty that there was no difference, and then

16 let the world evolve and pull out the data like we

17 had and then analyze it, just by random chance,

18 you would see something like that fairly often,

19 35 percent of the time. That's why statisticians

20 or econometricians look at something like that and

21 say that's really not sufficient evidence to tell

22 me that there is anything different about those

23 two effects.

24   JUDGE STRICKLER: It would occur by

25 random chance 35 percent of the time.

1   THE WITNESS: That's correct.

2   JUDGE STRICKLER: So it would occur,

3   therefore, not by random chance, 65 percent of the

4   time, which from a statistician or

5   econometrician's point of view, that would clearly

6   not be sufficient to prove the hypothesis?

7   THE WITNESS: So I'm not entirely sure

8   that you would then say 65 percent of the time --

9   so 65 percent of the time you would see something

10 less, you would see less of a difference than

11 that, and 35 percent of the time you would see a

12 difference that big or greater. And then,

13 correct, as you said, from a statistician's point

14 of view or from an econometrician's point of

15 view -- I mean, there's no econometrician or

16 statistician who would look at a p-value of .35

17 and say that that proves -- that that's any

18 evidence that there's any difference between those

19 things.

20   JUDGE STRICKLER: Would you say, as an

21 econometrician, that it's more probable than not

22 that it shows a mild effect that's promotional for

23 noninteractive versus interactive.

24   THE WITNESS: I wouldn't say that. I

25 think that's inappropriate. I've seen -- in other

1 situations, I've seen economists say, well, the

2 p-value is less than .5 and that means it's more

3 probable than not. But I think that's a

4 misinterpretation of what p-values are.

5   The hypothesis is are these things

6 equal, and the p-value says if they were not

7 equal, this is how often, what percentage of the

8 time you would see something like this just due to

9 random chance. So, to me, I see this, and the

10 p-value is high enough that it's just -- you know,

11 it's just not evidence that there's a difference.

12 I don't think you could look at it and say that

13 it's more probable than not that there is a

14 difference.

15   JUDGE STRICKLER: I understand that.

16 That leads me to another question I wanted to ask

17 you. It goes back to your critique and your

18 figure 6, which basically is a matter of showing

19 correlation and no causation whatsoever, which I

20 think counsel is trying to explore with you on

21 cross-examination.

22   THE WITNESS: Sorry, I don't know what

23 figure 6 is.

24   JUDGE STRICKLER: I'm sorry, figure 6 on

25 page 18.

1   THE WITNESS: Oh, yes, okay.

2   JUDGE STRICKLER: Because you didn't

3 control for any other factors, as you candidly

4 acknowledge. You just saw a correlation

5 between -- or, actually, perhaps I would say lack

6 of the correlation that was being advanced by

7 Professor Kendall.

8   THE WITNESS: So I wouldn't say that it

9 is just correlation. I mean, there is a natural

10 experiment going on here where, for reasons that

11 have nothing to do with consumers' preferences for

12 music and desire to purchase music, there's a

13 change in how often a song is being played. It's

14 true that there are other -- potentially other

15 changes going on in the market. So there's always

16 additional things in any analysis that you could

17 include. But I would object to the idea that it's

18 just causation -- that it's just correlation.

19 There is a natural experiment going on.

20   JUDGE STRICKLER: As an econometrician,

21 what is your level of statistical confidence with

22 regard to your conclusions from that natural

23 experiment in figure 6?

24   THE WITNESS: So I'm confident that -- I

25 don't have a p-value on this, right?

1   JUDGE STRICKLER: Why not?

2   THE WITNESS: I don't know, I didn't

3 calculate one. If I tested whether these things

4 are the same, I can say with strong confidence --

5 I can't give you the p-value -- that they're not

6 higher, right? We may be able to find that they

7 were lower, but they're not higher.

8   JUDGE STRICKLER: More probable than

9 not?

10   THE WITNESS: Looking at it and looking

11 at the table 1, I think it's pretty clear that

12 they're not higher.

13   JUDGE STRICKLER: So it's more probable

14 than not that they're not higher?

15   THE WITNESS: I think it's a fact

16 they're not higher. That's just a fact. That's

17 not something that's open to probability. I guess

18 the question that's open to interpretation is what

19 that means. I think it's a fact that they didn't

20 go up.

21   JUDGE STRICKLER: So you say it's --

22 because of that, it's more probable than not that

23 there was no promotional effect?

24   THE WITNESS: I would say that it's

25 evidence -- it's just further lack of evidence of

1 a promotional effect. That's maybe just

2 semantics, but I think the point is this is -- and

3 we talked a little bit about this in my direct,

4 right? It's sort of hard to prove a negative,

5 right? So what you could do is look at places

6 where you would say, well, if this is true, this

7 is what we would expect to see, and we look at it,

8 and we don't see it.

9   And this is another example of if there

10 was a promotional effect after there's a big boost

11 in plays on iHeart, well, you would expect to see

12 some bump in sales, and, again, you don't see it.

13 So I would say it's evidence of a lack of

14 evidence, if that makes any sense.

15   JUDGE STRICKLER: I understand. If you

16 had tried to control for the other factors as

17 counsel had questioned you about a moment ago,

18 would you then have been able to establish a level

19 of statistical confidence?

20   THE WITNESS: I don't think that makes a

21 difference. I think --

22   JUDGE STRICKLER: With all due

23 respect --

24   THE WITNESS: Sorry --

25   JUDGE STRICKLER: -- that wasn't my

1 question.

2   THE WITNESS: No, no, sorry, I --

3   JUDGE STRICKLER: My question is would

4 you have been able to calculate a level of

5 confidence if you had controlled for all the other

6 facts that you mean to control?

7   THE WITNESS: Sorry, what I meant to say

8 is it doesn't make a difference whether or not you

9 calculated it. I was trying to answer your

10 question. My apologies.

11   JUDGE STRICKLER: That's okay.

12   THE WITNESS: It just wasn't calculated.

13 You could calculate the -- the numbers are here.

14 You could calculate a p-value on a test of whether

15 the 20 percent is the same as the six numbers that

16 come later or whether the 201,000 is different

17 from the 183,000. So the reason it was done is

18 not because -- the reason it was presented this

19 way and I didn't calculate a p-value on these is

20 not because of not accounting for any of the

21 things that I was asked about, if that makes any

22 sense.

23   JUDGE STRICKLER: Thank you.

24   THE WITNESS: You're welcome.

25

1   BY MR. MILLER:

2   Q   I actually will have a couple questions

3   on the p-values, as exciting as that is.

4   A   I'm sure it's everybody's favorite

5   subject.

6   Q   But if I could finish up a couple

7   questions on the table 2 here. It's fair to say

8   that for the tests that you performed, for either

9   user group, it's true that, on average,

10 noninteractive users increase their purchase --

11 purchases of song downloads more than interactive

12 users did in the three-month period after they

13 started using a webcasting service, right?

14   A   The point estimates in the

15 noninteractive row are higher than the point

16 estimates in the interactive row, that's correct.

17   Q   So is that a yes?

18   A   On average, without accounting for the

19 variability, yes.

20   Q   Now, you were having a discussion with

21 Judge Strickler about the confidence levels or the

22 .35 p-value. What you were testing, you noted in

23 paragraph 43, was a hypothesis that the effect of

24 using noninteractive streaming services on

25 purchases of digital tracks is the same as the

1   effect of adopting use of an interactive service,

2   correct?

3   A   That's correct.

4   Q   So you're trying to test whether they

5   had the same effect, correct?

6   A   Right. I'm testing whether -- I mean, I

7   would say you're testing whether there's a

8   difference. Strictly how you do that in

9   hypothesis testing is you say, let's suppose there

10   is not a difference and then do we see something

11   that is consistent with that or not.

12   Q   And for the users in group B, you came

13   up with a p-value of .268, correct?

14   A   That's correct.

15   Q   So that means that you have a 73 percent

16   level of confidence that the hypothesis is

17   actually unproved, correct?

18   A   I don't think I would express it that

19   way. I think a p-value of .268, people often say,

20   well, there's a confidence of 1 minus that many

21   percentages. But what it means is that, again, if

22   the hypothesis that they were the same is true,

23   you would see something that extreme 26.8 percent

24   of the time just due to random chance.

25   Q   In fact, you used the term 73 percent

1 confidence, was the only reason I was using it,

2 there in footnote 53, I believe.

3   A   Right, that's what it says there. It

4 corresponds to a quote unquote, and I put quotes

5 on it because it's a little weird to say

6 73 percent confidence. But, exactly, the p-value

7 of X corresponds to a confidence level of 1 minus

8 X.

9   Q   Given that you found an actual

10 difference that we talked about between the

11 promotional effects of interactive and

12 noninteractive services based on the point values

13 you observed, how much confidence do you have in

14 the hypothesis that there is no difference?

15   A   I mean, I have as much confidence as you

16 can get after running a test and failing to reject

17 it. There's no -- statistical testing doesn't

18 work in such a way that there is a percentage that

19 you can put on that. As I said before, what it

20 tells you is this is something that wouldn't be

21 uncommon to see if the hypothesis were true. So

22 what -- I look at this and say, if the hypothesis

23 is true, this is something we would see so there's

24 no evidence here to tell me that the hypothesis is

25 false.

5993

1   Q   Well, you would agree, would you not,

2   that the analysis you performed certainly did not

3   support the conclusion that use of noninteractive

4   services leads to substitution of song downloads,

5   correct?

6   A   So I would say it's not inconsistent

7   with that because we have to keep in mind that all

8   these numbers are biased upwards for the reasons I

9   talked about yesterday.

10   Q   But either of the analyses that you

11   performed for B or C resulted in fewer song

12   downloads after someone started the use of the

13   noninteractive streaming service, correct?

14   A   That's correct.

15   JUDGE STRICKLER: I have a question for

16   you, Dr. Blackburn. If we utilize all music

17   stream as your column C --

18   THE WITNESS: Yes, sir.

19   JUDGE STRICKLER: Do your confidence

20   levels still apply to that now that you've changed

21   the sample to include those who are not buying any

22   music at all?

23   THE WITNESS: So the 26.8 p-value for

24   the difference is for column B, and there's a .35

25   p-value, which I think is in paragraph 45, for --

5994

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 1  if you look at column C.

 2            JUDGE STRICKLER:  Thank you.

 3  BY MR. MILLER:

 4       Q    I guess just one question to wrap this

 5  up.  So the econometric analysis you performed on

 6  iHeartMedia's produced data showed that it was

 7  more likely than not that the use of

 8  noninteractive services had no substitutional

 9  effect, correct?

10       A    Sorry, can you ask that again.

11       Q    Had no substitutional effect.

12       A    The use of?

13       Q    Noninteractive -- I'll ask it again.

14       A    Sorry.  That's okay, thank you.

15       Q    The econometric analysis that you

16  performed on the data produced by iHeart showed

17  that it was more likely than not that the use of

18  noninteractive services had no substitutional

19  effect, correct?

20       A    I mean, I don't know about more likely

21  or not.  It's consistent with it having neither a

22  substitutional nor a promotional effect, yes.

23       Q    You could not say there was any

24  statistically significant evidence that

25  noninteractive services substitute for digital
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5995

1   sales, correct?

2   A   That's correct, the analysis is

3   indistinguishable from -- there's no statistical

4   evidence that it's -- again, strictly talking

5   about digital downloads and ignoring all the other

6   revenue channels, because that's all the data

7   does, the evidence suggests -- there's no

8   statistical evidence of a promotional effect or a

9   substitutional effect from noninteractive services

10 or interactive services or any difference between

11 them.

12   MR. MILLER: No further questions.

13   THE WITNESS: Thank you.

14   CHIEF JUDGE BARNETT: Good morning.

15   MS. ABLIN: Good morning, Your Honor.

16   CROSS-EXAMINATION BY COUNSEL FOR NATIONAL

17   ASSOCIATION OF BROADCASTERS

18 BY MS. ABLIN:

19   Q   Good morning, Dr. Blackburn.

20   A   Good morning.

21   Q   I would like to start by discussing a

22 section of your testimony you didn't talk about

23 yesterday but you did talk about when you were

24 deposed a few weeks ago.

25   A   Okay.

5996

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 1      Q     If I could get you to turn to

 2  paragraph 61, which is on page 37 of your rebuttal

 3  testimony.

 4            CHIEF JUDGE BARNETT:  Ms. Ablin, can I

 5  ask which hat you're wearing today?

 6            MS. ABLIN:  Certainly, Your Honor.  So

 7  we've met before.  I'm Karyn Ablin.  I'm

 8  representing the National Association of

 9  Broadcasters.

10            CHIEF JUDGE BARNETT:  Thank you.

11      A     Paragraph 61, yes.

12      Q     Yes.  Now, you've asserted in that

13  paragraph that "The threat of losing potentially

14  paying customers to nonpaying illegal services

15  would cause rational negotiators for the directly

16  licensed services to demand lower royalty rates

17  and would cause rational negotiators for the

18  record companies to accept lower rates than

19  otherwise would be the case absent piracy"; is

20  that right?

21      A     That's correct.

22      Q     And in making that statement, you did

23  not attempt to quantify the effect of piracy on

24  the rates that are negotiated between the licensed

25  services and the labels, did you?
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5997

1   A   That's correct, it's not a

2   quantification exercise.

3   Q   You also didn't calculate

4   cross-elasticities of demand between unauthorized

5   pirated services and licensed services, did you?

6   A   No, that would be -- if I had done that,

7   the answer to the previous question would have

8   changed. That's a quantitative exercise.

9   Q   In preparing your testimony, you did not

10 analyze whether the presence of piracy affects how

11 a surplus in the service gets divided between a

12 service and a record company in a license

13 negotiation, did you?

14   A   That's correct, yes.

15   Q   And you wouldn't be comfortable saying

16 that piracy would move the division of surplus

17 between the record label and the licensed service

18 one way or another or not move it at all, correct?

19   A   That's correct. I'm comfortable in

20 saying that the rates are lower as a result, but

21 not whether whatever surplus there is, is being

22 split differently.

23   Q   If you could please turn now to

24 paragraph 23, which is on page 15 of your

25 testimony.

1   A   Okay.

2   Q   You state there that "A review of the

3 aggregate revenue trends in the music industry

4 over the past several years suggest that streaming

5 services are more than simply neutral in their net

6 promotion and substitution impact. The trends

7 suggest streaming services substitute for other

8 industry revenue sources."

9   Do you see that?

10   A   It says that, yes.

11   Q   And then you go on in that section to

12 present figures 2 through 5, which show various

13 types of trends related to streaming plotted

14 against overall recording industry sales; is that

15 correct?

16   A   Right. And they're similar to the

17 charts that I talked about here a few weeks ago.

18   Q   Let's take a look at one of those

19 figures, figure 4, which is on page 17 of your

20 rebuttal testimony.

21   A   Uh-hmm.

22   Q   Now, that figure provides a visual

23 comparison of the amount of revenues from

24 streaming services in general with the amount of

25 total recording industry sales for each year from

5999

1 2004 to 2013, correct?

2   A   It does.

3   Q   And you intended that figure to be a

4 fair visual depiction of these revenue trends,

5 correct?

6   A   I mean, I don't know what fair means,

7 but it's -- it's intended to show the trends, yes.

8   Q   You didn't intend to mislead anyone in

9 the way that this data was presented.

10   A   Absolutely not.

11   Q   But in presenting this comparison, you

12 have used very different scales to plot the

13 streaming revenues and the total industry sales

14 revenues, correct?

15   A   Well, you have to do that because if you

16 have the same scale, you can't see the trends.

17 You can just see the levels.

18   Q   And, in fact, the scale varies -- they

19 vary by a factor of 4, don't they?

20   A   That seems to be right, yes.

21   Q   So you said you had to do that to make

22 sure you could see the trend in the streaming

23 revenues? Is that what your testimony is?

24   A   Yes, I think that's right. If you put

25 the streaming revenues on the same scale, the

1 left-hand side, that the total sales are,

2 streaming is still a relatively small part of

3 total industry revenues. It's growing, as you can

4 see here. But I certainly don't -- I certainly

5 don't intend anybody to look at this and say, ah,

6 total streaming revenues are now as high as

7 digital and physical revenues were in 2013. It's

8 just -- it's about one fourth the size.

9   Q   Right. And by using these different

10 scales for the two sets of revenues, it gives the

11 appearance that the decline, just looking at the

12 bars as they're presented in this chart, it gives

13 the appearance that the decline of industry

14 revenues and the growth of streaming revenues are

15 more closely correlated than they are; is that

16 correct?

17   A   I mean, I don't think it changes the

18 correlation. The correlation is not subject to --

19 I mean, a correlation isn't subject to scale.

20   Q   Right. I'm just talking about the

21 visual appearance. Someone looking at this chart,

22 it gives the visual appearance that there's a

23 higher correlation than there actually is if

24 they're not paying attention to the two different

25 scales.

6001

1   A   I mean, I take it that maybe that's

2 possible. I don't see that. It may be because I

3 have spent years studying statistics and

4 econometrics and stuff like that, but it may be

5 possible.

6   Q   Let's take a look at an exhibit I'm

7 about to hand out --

8   A   Sure.

9   Q   -- which has been marked NAB 4236.

10   MR. CHOUDHURY: Your Honor, we object.

11 This is clearly a demonstrative that's never been

12 disclosed. There were no demonstratives or

13 exhibits disclosed for this witness from NAB, and,

14 clearly, they've done something with the data

15 which, you know, I can't know sitting here.

16   MS. ABLIN: Your Honor, this is simply

17 an impeachment demonstrative to impeach the

18 reliability and misleading nature of

19 Dr. Blackburn's figure 4 in his testimony. We're

20 not required to disclose impeachment

21 demonstratives, and I will represent to the Court

22 that this demonstrative was created using --

23 without doing new analyses of data. It was simply

24 the data and the Excel charts that we received in

25 discovery from SoundExchange related to

1 Dr. Blackburn's testimony.

2   CHIEF JUDGE BARNETT: Anything further,

3 Mr. Choudhury?

4   MR. CHOUDHURY: No.

5   CHIEF JUDGE BARNETT: The objection is

6 overruled. 4236 is admitted as a demonstrative.

7   (NAB Exhibit 4236 was admitted into

8 evidence.)

9 BY MS. ABLIN:

10   Q   Dr. Blackburn, does this figure in

11 NAB 4236 appear to show what your figure 4 would

12 look like if the same vertical scale had been used

13 for both streaming revenues and recording industry

14 sales?

15   A   I mean, taking your representation that

16 it uses the same underlying numbers that figure 4

17 does, I think so, yes.

18   JUDGE STRICKLER: I have a question for

19 you related to this and going to your figure 4,

20 which you probably have open in front of you.

21   The left-hand axis is -- you use the

22 phrase "total sales." On the right-hand axis, you

23 use "streaming revenue." Is there a reason why

24 you didn't also say just "total revenue" as

25 opposed to "total sales" on the left-hand axis?

1   THE WITNESS: They're the same thing. I

2 don't know why, at this point, why one says

3 "sales" and one says "revenue." It may be because

4 the revenue that comes in for streaming is not

5 sales revenue, it's licensing revenue.

6   JUDGE STRICKLER: I could understand why

7 that one would be revenue. But you had a choice,

8 I think, correct me if I'm wrong, calling the

9 left-hand axis "total revenues" instead of "total

10 sales."

11   THE WITNESS: Yes, that's correct. I

12 think it's -- honestly, I do not remember why. My

13 guess is it's because those are revenues from

14 sales and the other ones are revenues that aren't

15 from sales, just to make to distinction, but, to

16 be honest, I'm not certain about that.

17   JUDGE STRICKLER: Thank you.

18 BY MS. ABLIN:

19   Q   Dr. Blackburn, I think you testified

20 earlier, was it your idea to use two different

21 scales in plotting these two trends of revenues in

22 figure 4?

23   A   I mean, it's my report. Everything in

24 there is my ideas, yes.

25   Q   So it was your decision to do this.

1   A   Yes.

2   Q   And figure 4 alone does not show that

3 increased streaming revenues to the recording

4 industry has caused the decline in overall

5 recording industry revenues, does it?

6   A   I mean, we've talked about that at

7 length a couple weeks ago. It's -- this is not a

8 causal analysis. It's just showing that while one

9 is going up and one continues to grow, while

10 streaming is growing, total sales are falling.

11   Q   Let's take a look now at figure 5 in

12 your testimony. That's on page 18.

13   A   Okay.

14   Q   In presenting -- well, that figure

15 provides a visual comparison of the amount of

16 statutory royalties that SoundExchange distributed

17 with the amount of total recording industry sales

18 for each year from 2004 to 2013, correct?

19   A   That's correct.

20   Q   And in presenting this comparison,

21 you've actually decided to inflate the scale for

22 graphing SoundExchange's statutory royalty

23 distributions, as compared with total recording

24 industry sales amounts, by a factor of 10. Is

25 that correct?

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1   A   The scale on the left-hand side is ten

2 times the scale on the right-hand side, yes.

3   Q   I'm going to hand out another exhibit

4 for us to look at.

5   MR. CHOUDHURY: Your Honor, just for the

6 record, as long as it's being used solely for

7 impeachment. I would also note that I believe

8 these are also new to the exhibit list after the

9 start of the hearing.

10   CHIEF JUDGE BARNETT: They are marked

11 with new numbers. I think usually what happens is

12 these things appear and then later we assign them

13 a number. But 4237 is admitted for demonstrative

14 purposes only.

15   (NAB Exhibit 4237 was admitted into

16 evidence.)

17   MS. ABLIN: Thank you.

18 BY MS. ABLIN:

19   Q   Dr. Blackburn, you've now been handed an

20 exhibit that's been marked as NAB Exhibit 4327.

21 Do you see that?

22   A   I do.

23   Q   Does this figure show what your figure 5

24 would look like if the same vertical scale had

25 been used for both SoundExchange distributions and

1   recording industry sales?

2   A   I mean, I don't know. If you're willing

3   to make the same representation, then I could

4   answer the question.

5   Q   Yes. I'm happy to represent that this

6   chart was created from the same data that we

7   received in discovery from your counsel that had

8   been used as backup for the chart in your

9   testimony.

10   A   Right. So as long as the data are the

11   same, then that appears to be the case, yes.

12   Q   And was it also your idea to plot the

13   two types of revenues in this chart using two

14   different scales?

15   A   Yes, it was. I think here you can

16   really see what I was talking about before. If

17   you look at 2005, 2006, 2007, the scale is -- the

18   scale for the SoundExchange distribution is just

19   too wide that you can't really -- can't even tell

20   whether there's any change between 2005 and 2006,

21   but you can see a little bit better on the other

22   one. Maybe you should even use a bigger scale

23   because you're only using -- even in my figure 5

24   you're only using half of the vertical space to

25   show what's going on in SoundExchange.

1   And I'll note, because, you know, you

2   asked about this being misleading, if you read the

3   text around this, it talks about the specific

4   numbers. And the end of paragraph 24 even

5   explicitly says that the increase of about

6   300 million in distributions over a time period is

7   only about one third the approximately 900 million

8   dollar drop in sales over that time.

9   So, I mean, I hope that it's clear from

10 stuff like this I am not trying to mislead

11 anybody. I am doing this just because visually,

12 in order to see what's going on, you want to use

13 the visual space, and the scale is different

14 enough that, in my opinion, it warrants using

15 different scales for the different data, but I

16 certainly have no intention of misleading and

17 making anybody look at this chart and think that,

18 say, there's a one-for-one change on one hand for

19 the other.

20   Q   But you don't explicitly flag in the

21 text the fact that you've used different scales

22 other than the small print that goes up the right

23 side of this graph, do you? You might mention

24 numbers, but you don't explicitly tell the reader

25 that you're using different scales in the text, do

1 you?

2   A   It's on the charts themselves. So if

3 you're looking at the charts and you look at the

4 charts, you can see that it's there. I'm not

5 trying to pull the wool over anybody's eyes.

6   Q   Right, but it's not in the text.

7   A   It's not in the prose. It's in the

8 written testimony.

9   MS. ABLIN: No further questions.

10   CHIEF JUDGE BARNETT: Any questions,

11 Mr. Malone?

12   MR. MALONE: No, Your Honor.

13   CHIEF JUDGE BARNETT: Is there someone

14 here from Sirius?

15   MR. TOOF: Yes, Your Honor, Jackson

16 Toof.

17   CHIEF JUDGE BARNETT: Any questions for

18 this witness?

19   MR. TOOF: No, Your Honor.

20   MR. CHOUDHURY: No redirect.

21   CHIEF JUDGE BARNETT: Thank you,

22 Mr. Choudhury.

23   Thank you, Dr. Blackburn.

24   THE WITNESS: Thank you. It's been a

25 pleasure.

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 1                  (Witness excused.)

 2                       - - -

 3              ERIC L. TALLEY, Ph.D.,

 4  having been duly sworn, testified as follows:

 5              CHIEF JUDGE BARNETT:  If you could state

 6  your full name and spell your last name for the

 7  record.

 8              THE WITNESS:  Yes.  Eric L. Talley.  The

 9  last name is T, as in Tom, A-L-L-E-Y.

10              CHIEF JUDGE BARNETT:  Thank you.

11              MR. RICH:  Your Honors, on behalf of

12  Pandora, Mr. Ebin will be conducting our

13  cross-examination of Mr. Talley.

14              CHIEF JUDGE BARNETT:  Thank you,

15  Mr. Rich.

16    DIRECT EXAMINATION BY COUNSEL FOR SOUNDEXCHANGE

17  BY MR. BLAVIN:

18      Q    Professor Talley, where are you

19  currently employed?

20      A    I am currently the Rosalinde and Arthur

21  Gilbert Foundation professor of law and economics,

22  in the Law, Business, and the Economy division at

23  UC Berkeley.  As of July 1, 2015, I will be moving

24  to a tenured position at Columbia University where

25  I will hold the Sulzbacher professor of law.
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6010

1   Q   What is your educational background?

2   A   I hold a Ph.D. in economics from

3 Stanford University as well as a law degree from

4 Stanford law school, and a bachelor's degree in

5 economics and political science with a minor in

6 mathematics from the University of California San

7 Diego.

8   Q   What courses do you presently teach?

9   A   I teach a variety of courses in business

10 law and the economic analysis of law, including a

11 course in law and economics, contracts, mergers

12 and acquisitions, corporate finance, corporations,

13 and a set of sundry topics in business law as

14 well.

15   Q   Have you conducted research and

16 published articles in these fields?

17   A   Yes, I have.

18   Q   You've studied and published articles

19 specifically on bargaining in the shadow of legal

20 regimes?

21   A   Yes. The part of my research that

22 concerns bargaining in the shadow of law is

23 actually one of the largest portions of my

24 research dossier.

25   Q   Do you presently serve on any boards?

1   A   I do. I am an immediate past president

2   and director of the Society for Empirical Legal

3   Studies, which is -- I believe it's the largest

4   empirical legal studies academic society in the

5   world. I'm a past member of the Board of

6   Directors of the American Law and Economics

7   Association as well as program chair of the

8   sections of contracts and law and economics in the

9   Association of American Law Schools.

10   Q   Have you testified before as an expert

11   in litigation?

12   A   Yes, I have.

13   Q   How many times?

14   A   Well, I've been probably retained more

15   than two dozen times. I've testified, I believe,

16   four times now.

17   Q   And your entire curriculum vitae is

18   attached as an exhibit to your testimony?

19   A   Let me just check.

20   Yes, my CV as of November 14, what

21   appears to be a correct copy of it is attached to

22   my written rebuttal testimony.

23   MR. BLAVIN: Your Honors, we tender

24   Professor Talley as an expert in microeconomics,

25   bargaining and game theory, and economic analysis

1 of the law.

2   MR. EBIN: No objection.

3   CHIEF JUDGE BARNETT: Professor Talley

4 is so qualified.

5 BY MR. BLAVIN:

6   Q   Professor Talley, is this a true and

7 correct copy of the written rebuttal testimony you

8 submitted in these proceedings?

9   A   Just flipping through it, it appears to

10 be. I will not bother to try to reread it, but it

11 appears to be a correct copy.

12   MR. BLAVIN: Your Honor, SoundExchange

13 moves into evidence Professor Talley's written

14 rebuttal testimony, which is SoundExchange 19.

15   MR. EBIN: No objection.

16   CHIEF JUDGE BARNETT: Exhibit 19 is

17 admitted.

18   (SoundExchange Exhibit 19 was admitted

19 into evidence.)

20 BY MR. BLAVIN:

21   Q   Professor Talley, does this slide cover

22 your central criticisms of the analytical

23 approaches taken by Professors Katz and Shapiro,

24 as described in your rebuttal testimony?

25   A   I think this captures the core of it.

1 There are four modules on the slide that get at

2 most of it. I'll just cover them briefly, and

3 then we can go into them in greater detail.

4   The first concerns what has been called

5 the shadow of the statutory rate and the failure

6 of Professors Katz and Shapiro to account for how

7 that statutory rate can crowd out consensually

8 negotiated deals, leaving behind deals that

9 exhibit downward selection bias in their pricing

10 terms.

11   The second is that Professors Katz and

12 Shapiro ignore or suppress the effects that

13 competition in downstream markets can have on the

14 derived demand, as it were, or demand for inputs

15 of intermediate -- intermediate sellers, such as

16 the services in this case, and constrain their --

17 the upstream prices from getting too high.

18   The third is that Professors Katz and

19 Shapiro employ an approach that is inconsistent,

20 in my view, with the mandate in the statute of

21 what a hypothetical market of willing buyers and

22 willing sellers would produce in terms of prices,

23 and that renders their conclusions unreliable.

24   And the final is that they attempted to

25 distinguish interactive from noninteractive

1 services in a bargaining dynamic that purportedly,

2 according to Professor Shapiro, particularly, and

3 Katz, to some extent, would differ. I find that

4 unconvincing.

5   Q   Now, besides offering these criticisms

6 of Professor Katz and Professor Shapiro, did you

7 do anything else in your written rebuttal

8 testimony?

9   A   Yes, I did. I think the next slide

10 outlines that a little bit. I developed, as a way

11 to animate and illustrate and work through those

12 criticisms of Professors Katz and Shapiro

13 something that I guess most economists would call

14 a structural model approach, which is an attempt

15 to drill down to some of the core features of

16 economic transactions in a way that would bear on

17 the types of pricing behavior or other

18 institutional structures we might see from a

19 larger level.

20   Q   What were the ingredients of this

21 approach?

22   A   That is going to depend on exactly the

23 topic of where one wants to go with the structural

24 approach. In this instance, the structural model

25 was fashioned around trying to glean what a

6015

1 population of willing buyers and willing sellers

2 would do if transacting in a large decentralized

3 market.

4   So, as a result, the structural model

5 posits a set of heterogeneous distributions of

6 buyers and sellers and they differ in their

7 various willingnesses to pay, by buyers, for what

8 would essentially be bundles of licenses in this

9 market, and sellers, who are heterogeneous in

10 terms of their willingness to accept. And the

11 willingness to pay and willingness to accept are

12 factors, are one of the core benchmarks, not the

13 only ones, for trying to understand how a

14 negotiation between these parties would play out.

15   So these agents within this structural

16 model are then randomly selected to negotiate with

17 one another, and there's not always a deal that

18 would be had in this underlying model, but if

19 there is, then they would pursue, sort of,

20 standard bargaining protocols from the economics

21 literature and generate a price. Those prices, in

22 turn, would then generate a distribution of prices

23 that come out of this framework.

24   Q   After developing this framework, how you

25 did you analyze it?

1   A   I did it in two ways.

2   Because the framework actually drills

3 down to economic models of bargaining in a

4 decentralized market setting, it lends itself to a

5 very, sort of, conventional analysis using

6 equilibrium concepts that's quite conventional

7 within economics. And the appendix, the second

8 part of the appendix to my written rebuttal, in

9 fact, includes that technical analysis. And it's

10 one that's very general. It doesn't, for example,

11 commit to a particular, you know, distributional

12 form of what those buyers and sellers look like in

13 the overall population. It leaves it very open

14 and derives some very general results.

15   That's hard to digest, quite frankly, in

16 the body of a report. So the report itself then

17 goes into some simulations based on that model,

18 based on a particular distributional set of

19 assumptions, essentially to illustrate many of the

20 claims that are demonstrated in the appendix.

21   Q   These are referred to as Monte Carlo

22 simulations?

23   A   Yes. These are essentially drawing

24 hundreds of thousands -- tens or hundreds of

25 thousands of these buyer-seller dyads having to

1 negotiate and generate prices. That will, if one

2 samples enough from this -- from this simulation

3 framework, generate distribution prices. That's

4 conventionally known as a Monte Carlo simulation.

5   JUDGE STRICKLER: Good morning,

6 Professor.

7   THE WITNESS: Good morning.

8   JUDGE STRICKLER: How are you, sir?

9   THE WITNESS: I'm well. How are you?

10   JUDGE STRICKLER: Fine, thank you.

11   You refer to the willing buyers and

12 willing sellers in your simulation as

13 heterogeneous. What elements did they have in

14 this simulation? What made them heterogeneous?

15 Was it with regard simply to their willingness to

16 pay and willingness to accept, other factors?

17 Could you describe it?

18   THE WITNESS: Yes. So the underlying

19 fundamentals that would make buyers and sellers

20 differ or differ from one another or differ from

21 similarly situated buyers could be anything within

22 this model. So it could be driven by different

23 tastes. It could be driven by different economies

24 of scale. It could be driven by quality

25 parameters. So there might be a particular bundle

1   of a license that has very high-quality artists

2   and a buyer -- and buyers in general. Maybe some

3   buyers would be more attracted to that.

4   So the model is deliberately, I guess,

5   ambivalent about committing to a particular reason

6   that the buyers and sellers would be

7   heterogeneous. There are many economic accounts

8   that would give rise to that heterogeneity. I

9   believe the model is consistent with many of

10   those.

11   JUDGE STRICKLER: So those underlying

12   factors lead to heterogeneity with regard to

13   willingness to buy -- willingness to pay,

14   willingness to accept, but otherwise not

15   described, just assuming a variation in reasons

16   why we would get to these heterogeneous

17   willingness-to-accept and willingness-to-buy

18   parameters?

19   THE WITNESS: The distributions

20   themselves are organic to the simulation. But

21   part of that, I think, is that I didn't want to

22   have to commit to a particular reason. There are

23   many kinds of reasons that buyers and sellers

24   might differ in their willingness to pay and

25   willingness to accept. And if one commits to a

6019

1 particular account, then the generality of the

2 model is actually compromised.

3   JUDGE STRICKLER: Thank you.

4   THE WITNESS: Thanks.

5 BY MR. BLAVIN:

6   Q   Are such simulations frequently used in

7 economics?

8   A   Yes, they're used quite frequently in

9 economics for a variety of reasons. One might be

10 to simply illustrate, as I've done here, some

11 general propositions that can be derived

12 analytically but are kind of hard to get your mind

13 wrapped around. Another could be if a

14 simulation -- that's also, to some extent, present

15 here -- give rise to distributions that can be a

16 little bit complex, simulations can help

17 understand and inform intuitions about what those

18 distributions are going to look like.

19   And, third, simulations are often a core

20 block or a core stage in calibrating a model,

21 essentially using a simulation with particular

22 parameters, ask how well the data fit it, tweaking

23 the parameters, and readjusting the simulation.

24   Q   Can you provide any real-world examples

25 in which such simulations would be used.

1   A   Yes. They're all over the place, quite

2 frankly. Particularly within the government, with

3 a government agency that's required to conduct a

4 cost-benefit analysis of, say, a new financial

5 regulation or a new health regulation, it's quite

6 common to use simulation, a Monte Carlo simulation

7 analysis to determine what are the likely effects

8 of an underlying change, drilling down to what the

9 structural relationship is among the parties who

10 are going to be affected by that change.

11   Within the financial services industry,

12 it's extremely common to think about how to

13 understand, say, new financial products or

14 derivatives by asking how could things evolve in

15 the future and what is the overall distribution of

16 risks going to look like in the future. So

17 simulation Monte Carlo approaches are very, very

18 common within that context as well.

19   Policy think tanks -- I was affiliated

20 with the RAND Corporation for ten years in the

21 Institute for Civil Justice. Many of the things

22 that we were asked to do was -- were essentially

23 endeavors to understand, well, if we change the

24 fee-shifting rule or if we change the standing

25 rule, how would that change the way litigation

1   takes place in practice.

2   And we were able to use, quite

3   successfully, I think, some simulation approaches

4   to understand things like how litigation would

5   play out if we changed some of the underlying

6   rules.

7   Q   You noted earlier that simulations can

8   be an important step in calibrating a model to

9   real-world data. Did you do that calculation

10 here?

11   A   I didn't do that for the purposes of my

12 rebuttal testimony mainly because it wasn't

13 necessary. The purpose of the simulation in this

14 rebuttal was to help flesh out and to animate both

15 the general more theoretical results of the

16 structural modeling, which is in the appendix, but

17 also because I was called in as a rebuttal witness

18 for Professors Katz and Shapiro. So the critiques

19 of their approach come immediately out of that

20 structural approach without having to calibrate

21 that model. Had I been asked to affirmatively

22 come forward with my own estimates of fair rates,

23 then a next step might have been to calibrate this

24 model.

25   Q   Now, when you say that Professors

6022

1   Shapiro and Katz failed to offer a satisfactory

2   account of "how the statutory license may crowd

3   out consensually negotiated deals," what do you

4   mean by that?

5   A   Well, I think it starts back with what I

6   was discussing before, that within this structural

7   framework of buyers and sellers within these

8   populations that have heterogeneous willingnesses

9   to pay and accept, those individual negotiations

10   are going to give rise to a range of negotiated

11   prices.

12   I think I've got a demonstrative here

13   that will just heuristically give you a sense of

14   what's going on. Just imagine that we've got,

15   say, 30 negotiated contracts. This is in the

16   hypothetical market in which there is no shadow of

17   a statutory regime. And we've got buyers and

18   sellers who are getting together, and if the

19   buyer's willingness to pay exceeds the seller's

20   willingness to accept, that's going to give rise

21   to a bargaining range. Somewhere in the middle of

22   that range, depending on the bargaining power of

23   the parties, they're going to reach a deal.

24   So these blue dots essentially represent

25   an effective per-play price that would come out

1 from these, sort of, heuristically generated

2 deals. This is really for illustrative purposes

3 only.

4   MR. BLAVIN: Your Honor, just so you

5 know, this is displayed on the back of the screen

6 there as well.

7   THE WITNESS: I may seek your

8 indulgence. I've got some animations of these

9 slides. I apologize in advance for you having to

10 crane your necks, but Professor Katz had the white

11 bird and the black bird. What else could I do.

12   JUDGE STRICKLER: White swans and black

13 swans.

14   THE WITNESS: Oh, yes, exactly.

15 BY MR. BLAVIN:

16   Q   So how does the imposition of a

17 statutory rate change things?

18   A   If one were to take this hypothetical

19 market, very decentralized market, and impose a

20 statutory rate, this is essentially creating what

21 an economist would refer to as a real option, that

22 the purchaser or the buyer, and only the buyer in

23 this circumstance, would have the ability to say,

24 well, I guess I could negotiate a deal using the

25 same sort of negotiating protocol that we've been

1   thinking about earlier or I could just go to the

2   statutory rate and exercise my option to purchase

3   a license non-consensually without having to

4   bargain. So that statutory rate creates this

5   option in the hands of the buyer.

6   And, here, one of my less exciting

7   animations, is an imposition of a statutory rate.

8   I've just picked arbitrarily a statutory rate of

9   20/100, but, again, this is for illustrative

10   purposes only. So one can imagine that in this

11   circumstance some of the buyers in those

12   negotiations would now be looking to that

13   statutory rate as a potential option for them.

14   Q   What are the consequences of buyers

15   having this real option?

16   A   Well, as you can imagine, it's not --

17   it's not particularly hard to imagine it, that in

18   a situation where a buyer now has an option to

19   purchase at the statutory rate level, then she or

20   he or it is going to think, well, if that's a

21   better deal than the deal I would have otherwise

22   negotiated, then I'm going to consume at the

23   statutory rate rather than to negotiate a

24   transaction. And if you can go back, maybe, to

25   that slide, we can sort of see what would happen

1   here.

2   So imagine, for instance, Mr. Blavin,

3   that you and I, let's take that third transaction

4   in on this chart. It's one that goes off at a

5   negotiated rate in the absence of a statutory rate

6   at around 25/100 of a cent per-play -- effective

7   per-play rate. Let's just suppose for argument's

8   sake that I was the seller and you were the buyer,

9   and as a buyer, you valued at, say, 28/100 of a

10 cent and, as a seller, I valued at 22/100 of a

11 cent, and we reached a deal that was right in the

12 middle, all right?

13   So you as a buyer now are realizing that

14 you could just go through this deal or negotiate

15 this deal with me at 25/100 of a cent, but you now

16 have another option. You can consume at -- and

17 purchase from me on a non-consensual basis for

18 20/100 of a cent. That's going to be true for

19 just about for every one of these blue dots that

20 is above the line that would reach a price in

21 excess of the statutory rate. Buyers are going to

22 find it in their economic interest to exercise

23 that option.

24   So here, what I can -- I'll ask you to

25 start my little animation here -- what's going to

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1   happen is those blue dots are essentially going to

2   converge to the statutory licensing rate line.

3   Those transactions are essentially going to be

4   converted from consensual transactions at an

5   assortment of rates to non-consensual transactions

6   at the statutory rate.

7   Q   You said there was a second consequence

8   as well, I believe.

9   A   There is a second consequence as well.

10 It's a little bit more subtle and slightly more on

11 the fringes, but it turns out that not all the

12 action is in those deals that would have been

13 negotiated above the statutory rate. There are

14 some deals that would have been negotiated below

15 the statutory rate that might actually converge up

16 to the statutory rate. I think I've got another

17 demonstrative here as well.

18   So now I want you to imagine,

19 Mr. Blavin, that you and I are negotiating over in

20 that fourth column and but for the statutory rate,

21 we would have reached a deal at, say, 19/100 of a

22 cent per play. I -- think that's approximately

23 where that blue dot is -- but that you were

24 someone who valued at, you know, 24/100 of a cent

25 and I valued at, say, 17. And that's where we

1   would have been in the absence of the statutory

2   rate.

3   Now, in this case, that statutory rate

4   doesn't look as good to you as the purchaser as

5   purchasing consensually at 19/100 of a cent. But

6   to me as the seller, I now realize that if I

7   simply refuse to bargain with you, then you will,

8   in fact, resort to the statutory purchase.

9   And so the interesting effect here is

10 that sellers who know that they're facing a buyer

11 that would consume at the statutory rate anyway

12 will say, look, I'm not interested in bargaining,

13 go ahead and just consume at the statutory rate.

14 Now, that's typically going to be those buyers --

15 by definition, it's going to be those buyers that

16 value more than the statutory rate. And, as a

17 result, the deals below this line that might get

18 sucked up into it are going to tend to be the ones

19 that are, sort of, close to the line already,

20 inside the gravitational pull, if you will, of

21 this line.

22   So here's another small animation here

23 of the dots -- of a few of the dots going up.

24   JUDGE STRICKLER: Excuse me, Professor,

25 I just want to go back to your most recent

1   hypothetical. You had a willingness to pay of 19,

2   and what was that willingness to pay in that

3   hypothetical?

4   THE WITNESS: The willingness to pay on

5   that, I think I said 22.

6   JUDGE STRICKLER: Oh, 22.

7   THE WITNESS: Yes. And that's critical,

8   Judge Strickler, because the crowding up, if you

9   will, using the geometry in this slide, depends on

10 the seller realizing, hey, if I don't negotiate

11 with this buyer, this buyer will still consume at

12 the statutory rate. So now even though we would

13 have reached a deal below it, I can force a

14 transaction by just not bargaining above that

15 statutory rate. So here there's going to be a

16 small number of these transactions, not all of

17 them, by any means, that are inside the

18 gravitational pull and go ahead and -- so you're

19 going to see some of those converge to the

20 statutory rate as well.

21   Now, there still will be some deals --

22 as long as the statutory rate isn't too low, there

23 still will be some deals left over, but they'll

24 tend to be down below the line.

25

1 BY MR. BLAVIN:

2   Q   And Professors Shapiro and Katz have

3 suggested that the value of deals may be driven up

4 or pulled up by the magnet effect of the statutory

5 rate. Is this a version of that?

6   A   Well, I think it could be a version of

7 what they're talking about. I wasn't entirely

8 clear what they're discussing, but this is one

9 phenomenon in which there would be some deals that

10 would go off below the statutory rate

11 consensually, and they're sort of close to the

12 statutory rate, that actually would now become

13 non-consensual deals at the statutory rate.

14   Q   So why does this matter?

15   A   Well, it matters insofar as one is

16 interested in looking at precedent transactions to

17 help understand or benchmark any set of inferences

18 about what this whole population would look like

19 without the statutory rate. So this gives rise --

20 I think I'm done with my animation, by the way.

21   This gives rise to a phenomenon that I

22 think you've probably heard before that's called

23 selection bias, which says if we're trying to

24 infer something about a larger data set, then we

25 need to be mindful of whether what we are

1   observing in practice is systematically skewed to

2   the left or to the right of the set of, you know,

3   characteristics that we're ultimately interested

4   in.

5   JUDGE STRICKLER: Professor, in this

6   case -- in the discovery phase of this case, we

7   had permitted discovery with regard to parties'

8   internal valuations, that is we specifically said

9   their willingness to pay and their willingness to

10 accept. If you were armed with that sort of

11 internal information through the discovery

12 process, would you be able to -- can we go back to

13 the last animation for a moment, Mr. Nickels? --

14 would we be able to fill in, have actual

15 information to the extent that we had information,

16 documents, deposition testimony with regard to

17 what willingness to accept was, what willingness

18 to pay was, to find out whether the dots were both

19 above and below the existing statutory line or any

20 line whatsoever, and that way we would take this

21 theoretical point and actually be able to put some

22 factual meat on the bones, so to speak?

23   THE WITNESS: I think I understand the

24 question. The answer is they would be a promising

25 source of information. If, going into a

1 negotiation you had what you thought were quite

2 reliable estimates of the parties, maybe there are

3 different scenarios that they laid out with

4 different probabilities, that might help get a

5 sense of where those willingness to pay and

6 willingness to accept values are. That could be

7 different expectations about the future. This is

8 exactly one dimension of heterogeneity that I want

9 to remain open to that I think the structural

10 model would admit.

11   JUDGE STRICKLER: The way the Monte

12 Carlo simulations that you speak of, you have

13 these large variations, large amount of

14 heterogeneity, through the discovery dealing with

15 the actors who are actually involved in this

16 proceeding, we would be able to look at a, I don't

17 want to call it a subset, but the actual set of

18 bargaining parties. To the extent we have that

19 information, would that allow us, again, to repeat

20 myself, to move from the theoretical to the

21 practical?

22   THE WITNESS: So I think that would be a

23 helpful piece of information, maybe not the only

24 piece of information that you would be interested

25 in if you were trying to calibrate it. But,

1 ultimately, I think you see where I'm going on

2 this, but I'll probably go there anyway because we

3 have a slide deck, after all. But that when we

4 observe transactions out there, we are observing

5 them from this lower stripe.

6   So one of the things to concern yourself

7 with is, all right, these are the ones that didn't

8 get sucked up into the statutory regime.

9   JUDGE STRICKLER: Right. And that is a

10 point I know you'll be headed to because your

11 point is, if you look at the Pandora-Merlin

12 agreement, for example, it will be below the

13 stripe because you can view it, but there may be a

14 whole host of them, perhaps, that could have been

15 above the stripe that you'll never see because

16 they get pulled down, but that's because we're

17 looking at transactions. The whole point of

18 discovery, of course, is to peel away the curtain

19 and see what willingness to pay and willingness to

20 accept were, and that's why I asked you the

21 question of whether that would be helpful data to

22 find out where these points really are.

23   THE WITNESS: Yes, I'm with you on the

24 logic here. One of the things that would be --

25 I'd be a little bit concerned about, quite

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1 frankly, if we had a non-consensual deal that

2 might have been a consensual deal and we had

3 access to projections about, you know, valuations

4 had they reached a deal, how serious would those

5 projections be. So I don't even know that we

6 would get them, quite frankly, with a lot of these

7 non-consensual deals.

8   JUDGE STRICKLER: Although in the law

9 and economics field, and in economics in general,

10 we deal with rational actors. If they have

11 projections, we have to take their projections as

12 the rational expectations of the future. It

13 doesn't mean they're right. We just assume them

14 to be rational because otherwise I guess it would

15 be irrationality, and then we're hopelessly lost.

16   THE WITNESS: I agree. This structural

17 model is, in fact, based upon a rational actor

18 scenario. It's just the question of what kind of

19 data would we have available from those

20 non-consensual deals in which there doesn't really

21 have to be any bargaining at all, right? So you

22 may not have as many of those -- as rich a source

23 of data for those deals.

24   JUDGE STRICKLER: Because they wouldn't

25 even have the sense to bargain, you're saying.

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1   THE WITNESS: Right.

2   JUDGE STRICKLER: Thank you.

3 BY MR. BLAVIN:

4   Q   Now, notwithstanding this selection bias

5 issue, does that mean that you wouldn't look at

6 any market data that might exist?

7   A   No, it doesn't mean I wouldn't look at

8 market data that exists. I think this actually

9 touches on the discussion that Judge Strickler and

10 I were just having, that the deals that are

11 generated -- there still may be deals that are

12 generated within this tail of the distribution.

13 Those are informative, particularly if one is

14 trying to determine what the overall distribution

15 is, keeping in mind that one is in the tail of the

16 distribution. So they can still be informative.

17 I wouldn't want to rest completely on those, and

18 there may be other market data that are also

19 available.

20   So, for example, I think I've got

21 another demonstrative. And I'm going to flip the

22 axes on you here to do something that's a little

23 bit more conventional, sort of, you know,

24 histogrammy or frequency distribution related. So

25 this is, you know, heuristically representing that

1 same set of deals or similar set of deals that

2 give rise without a statutory rate to some

3 distribution of prices, and they are, sort of,

4 stacked up in terms of their -- you know, the

5 probability density within that population. So

6 this is, kind of, a standard bell curve type

7 distribution.

8   And imagine that we dropped a statutory

9 rate right down in the middle. Well, as I noted

10 earlier, everything to the right side of that

11 statutory rate is now going to become a

12 non-negotiated, non-consensual statutory

13 transaction. Essentially, it's going to crowd out

14 that half, in this case, of the distribution. A

15 few of the deals on the left-hand side of that

16 line might also get sucked up into the statutory

17 rate.

18   I think this gets back to this question

19 of inference. So what we would be dealing with,

20 from an empirical frequency perspective, is no

21 longer a bell curve but a curve that's got this

22 big spike right at the statutory rate and then

23 sort of a skewed or a catawampus bell curve left

24 over on the left-hand tail.

25   So another source of information that we

1 might use is what's the frequency with which these

2 non-negotiated deals are going off because that

3 would at least give us some indication of how many

4 of these deals got cut off of the top half of the

5 distribution.

6   There might be other information that we

7 would use as well. For instance -- and I

8 understand Professor Rubinfeld has used the

9 interactive market or interactive space of this

10 market as a way to say, well, is there a portion

11 of this market that actually isn't subject to the

12 statutory licensing rate, and, in that

13 circumstance, that might be another source of

14 information that's available.

15   Q   So what are the implications of this for

16 Professor Shapiro's approach and specifically his

17 reliance on the Pandora-Merlin deal?

18   A   Well, I think there are a couple of

19 them. First of all, so Professor Shapiro has put

20 forward a -- one deal drawn from the negotiated

21 transactions that survive the imposition of a

22 statutory rate. That inference is something that

23 doesn't try to account for the fact that it's

24 being drawn from a tail of the distribution and a

25 left tail of the distribution. So that's one area

1 that I take issue with Professor Shapiro. He

2 doesn't make any adjustments for the fact that

3 this deal is -- may be representative, may be not,

4 from the tail of the distribution.

5   The other part is it's one deal and it

6 doesn't consider all the market data, other deals

7 that may have been negotiated in the shadow of the

8 statutory rate, the non-consensual deals and the

9 frequency of uptake of non-consensual deals, as

10 well as nearby spaces in this market, such as the

11 interactive space, where we might be able to glean

12 a little bit about willingness to pay and

13 willingness to accept, after also making

14 adjustments for any distinguishing features of

15 that space.

16   So I think it's the combination of not

17 using more than one deal and also not making

18 adjustments for the fact that we are looking at a

19 tail of the distribution.

20   Q   Professor Shapiro testified at the

21 hearing that the existence of the Pandora-Merlin

22 agreement contradicts your analysis. What's your

23 response to that point?

24   A   I don't see how it contradicts the

25 analysis. I think that my recollection -- and I

1 did read through Professor Shapiro's testimony,

2 his testimony transcript. I think he was making

3 the point that Pandora is a high-valuing -- a

4 high-valued company, I guess. It's a large

5 company. It's not a small player. And,

6 therefore, it wouldn't be one of these low-value

7 transactions or low-volume transactions that

8 survives the imposition of the statutory rate.

9   I'm not so sure that's the case, for the

10 following reason. Even though it's clear Pandora

11 is a very large player in the noninteractive

12 space, the thing that one is negotiating over

13 matters as well. In this case it wasn't the

14 catalog of a major label. It was Merlin. And

15 there was, as I understand it, even options for

16 the various parts of Merlin to decide to go into

17 that deal or not. So it was a much smaller player

18 within Pandora's overall portfolio of songs. So

19 it could well be the case that Pandora is a

20 high-value company but just doesn't value this

21 particular bundle of assets very highly.

22   Q   Does the mere fact that an agreement

23 exists below the statutory rate demonstrate that

24 your analysis is incorrect?

25   A   No, it's completely consistent with the

1   analysis. I guess in the extreme case where we

2   were to set the compulsory license rate at zero,

3   you wouldn't see any more of those deals. But

4   it's completely consistent with my analysis.

5   Q   So what would happen if the

6   Pandora-Merlin agreement became the basis for the

7   next statutory rate?

8   A   Well, I think this is kind of an

9   important point. Do you mind if I use the Elmo

10   here? I'm going to draw on it. So let me just

11   switch places here. I want you to -- I'm going to

12   try to recreate, the best I can, that distribution

13   that I put up a few slides ago, all right, of

14   rates. This is essentially the distribution that

15   would be negotiated in the absence of a pureplay

16   rate -- excuse me, of a statutory royalty rate.

17   And let's suppose, again, like we

18   dropped a statutory rate somewhere down the

19   middle. That's immediately going to have the

20   effect of crowding out these transactions and

21   essentially creating a spike here, all right? The

22   remaining transactions that we'll actually observe

23   are going to look somewhat similar to that. There

24   might be a little bit of a falloff, all right?

25   And that's where we sit.

1   Now, as I understand, Professor Shapiro

2   has taken a transacted deal from the shadow of

3   this truncated distribution now, all right. And

4   let's suppose, just for argument's sake, and it

5   will be clear in a second -- I don't think this is

6   a particularly good idea, but let's suppose for

7   argument's sake that that became the new statutory

8   rate for the next five years, all right? We're

9   going out with the old and in with the new, and

10 we're moving that statutory rate further down.

11 Well, I now want you to flash forward in five

12 years and ask what's the set of deals that we're

13 going to be looking at that are negotiated in the

14 shadow of that new rate?

15   MR. EBIN: Excuse me. Objection, Your

16 Honors, this has now gone way beyond the scope of

17 what's in Professor Talley's written rebuttal

18 testimony.

19   MR. BLAVIN: Your Honor, may I respond?

20   CHIEF JUDGE BARNETT: Yes.

21   MR. BLAVIN: This point is made

22 essentially throughout his testimony. We

23 distributed demonstratives of these histograms

24 before, and he's just illustrating it through the

25 use of an Elmo. As numerous experts have done

1 here, they're just putting some flesh on their

2 points. And he is specifically rebutting

3 Professor Shapiro, who came in and offered

4 testimony on this issue.

5   CHIEF JUDGE BARNETT: Overruled. I

6 don't think it's that far afield.

7   A All right. Well, I'm almost done

8 anyway.

9   If you want to -- if you want to then

10 think, well, what kind of data are we going to see

11 then five years from now under this new regime?

12 Well, it's not going to be those same deals, all

13 right? Now there's going to be a set of deals

14 that are similarly crowded out from above and a

15 new distribution that's even further down would

16 take hold, which possibly Professor Shapiro might

17 be available to come in and offer another

18 contract, and you can see which way this would go

19 if this were the -- if this was a pattern of

20 responding to these sorts of deals.

21   But, essentially, it's a turtles all the

22 way down phenomenon, that we would increasingly

23 contract and contract and contract to the

24 left-hand tail of the distribution.

25   JUDGE STRICKLER: I just want to make

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1 sure I understand something at a more general

2 level with regard to your criticism of

3 Dr. Shapiro's point as it relates to the use of

4 the Pandora-Merlin agreement.

5   This particular criticism you have

6 relates to that dynamic effect you talk about in

7 five-year iterations as we move to the left on the

8 graph that you created. This particular part of

9 your testimony is not a criticism of the steering

10 impact that Dr. Shapiro speaks of in the

11 Pandora-Merlin -- that he sees evidenced in the

12 Pandora-Merlin agreement. You have other

13 criticisms of that later on, but this criticism is

14 geared to the rate and using the rate because it

15 falls to the left of the statute, given that it's

16 a dyad of Pandora and Merlin?

17   THE WITNESS: Yes, this criticism is one

18 that is independent of my criticisms of the

19 steering point.

20   JUDGE STRICKLER: That's the point I

21 wanted.

22   THE WITNESS: Even if there were no

23 steering, steering were impossible, steering

24 weren't completely possible, this sort of

25 phenomenon would be something that we should be

1   concerned about. It's not that that contract

2   shouldn't matter. It should inform us. But we

3   have to understand what we are observing in those

4   contracts are draws from a tail of the

5   distribution and make adjustments accordingly, or

6   you do end up running into this type of a danger.

7   JUDGE STRICKLER: Do we understand that

8   it's an example of the tail of the distribution or

9   do we understand that it may be in the tail of the

10   distribution?

11   THE WITNESS: It's possible. I believe

12   that Pandora has asserted that this is -- this is

13   a deal that has gone off at below the statutory

14   rate, which would be completely consistent with

15   this underlying model.

16   JUDGE STRICKLER: Well, that assumes

17   that the statutory rate has a certain particular

18   legitimacy or lack of legitimacy, if the statutory

19   rate had been set by previous judges

20   extraordinarily high this might not be in the

21   tail, it might be well within the middle of the

22   pack. So we would need more evidence to determine

23   whether it is indeed in the tail or not in the

24   tail.

25   THE WITNESS: So it's clearly in the

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1   tail. The question is how fat the tail is. I

2   think that's your -- that's what you're asking.

3   JUDGE STRICKLER: How do we know it's in

4   the tail?

5   THE WITNESS: Right. So one way that we

6   can try to assess that is to ask, well, to what

7   extent do we see uptake of non-consensual deals.

8   That will give us some sense of how far into the

9   tail that we are. Imagine that the statutory rate

10   were set at infinity or some arbitrarily high

11   number. That number of non-consensual deals would

12   go to zero, right? And then you've got pretty

13   much the whole distribution.

14   JUDGE STRICKLER: Well, it's not

15   precedent for us, but we have statutory rates that

16   were set in Web II, going back to Web II, and then

17   we see a lot of negotiation resulting in rates

18   that are lower. Those rates aren't precedent for

19   us at all because Congress has told us they're not

20   precedential.

21   But consistent with your theory, we have

22   set statutory rates, and then we see bargaining

23   for, perhaps, a host of reasons. Like you said,

24   we've lost some heterogeneity out there, but we

25   see bargaining and we end up seeing pureplay

1 rates, small pureplay rates, Settle- -- Webcaster

2 Settlement Act rates for the NAB, Webcaster

3 Settlement Act rates for SiriusXM.

4   So at least under your theory, it

5 suggests that the rate would be higher, not

6 infinity because it wasn't infinity, but it was

7 set at whatever it was set at, and then we saw

8 bargaining thereafter. Now, there may be other

9 reasons for bargaining, but we have seen

10 bargaining off the statutory rate. Wouldn't that

11 be consistent with the idea that rates below the

12 statutory rate might have suggested that the

13 statutory rate was too high?

14   THE WITNESS: I'm not so sure that's the

15 case. The fact of the matter is, you're going to

16 see -- there's going to be incentive to bargain so

17 long as the statutory rate isn't zero. There are

18 going to be dyads of buyers and sellers that would

19 be willing to bargain.

20   One of the critical issues is how

21 frequently is that happening versus non-consensual

22 transactions, for example.

23   JUDGE STRICKLER: I guess the question

24 is -- again, and I want to emphasize, this doesn't

25 make those rates precedential, but if it were the

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1 case that nobody was operating at the statutory

2 rate and everybody had decided to enter into side

3 deals and they were all to the left of the

4 statutory rate and we didn't see anybody operating

5 at the statutory rate, if that was the situation,

6 under your theory, would that be suggestive of the

7 fact that the statutory rate was too high and that

8 those rates were not in the tail at all but were

9 more towards the middle?

10   THE WITNESS: Yes, I think I understand

11 your question. It may be another version of the

12 set it at infinity. You're just saying set it at

13 such a large number that no one would ever do a

14 non-consensual deal. And I think that's right,

15 that if you set it at such a point that

16 non-consensual deals completely disappear, then

17 all you would see in this distribution is

18 consensual deals.

19   JUDGE STRICKLER: Thank you.

20 BY MR. BLAVIN:

21   Q   Just following up, you would want to

22 look at the number of parties who opted for the

23 statutory license?

24   A   Absolutely. So one of the things

25 that's -- and I think my discussion just now with

1 Judge Strickler bore that out a little bit is that

2 when you could try to glean, well, what does this

3 distribution look like, is that not only to look

4 at what are the deals we observe in the tail of

5 the distribution but, also, how high is that

6 spike, how much of the other side of this

7 distribution may have been cut off. So both of

8 those pieces of data and possibly others, as I

9 mentioned earlier, in the interactive space might

10 be relevant inputs.

11   MR. BLAVIN: If we can go back to the

12 slides.

13 BY MR. BLAVIN:

14   Q   So with respect to your second point,

15 your second criticism, can you please explain what

16 you mean by "competition from the downstream

17 consumer market can constrain price in the

18 upstream licensing market"?

19   A   Sure. The market for services in this

20 instance is one of, essentially, an intermediate

21 supplier. They sell to a downstream market of

22 consumers. They serve as a downstream market of

23 end listeners, and then purchase inputs, in

24 particular, licensing bundles from upstream

25 suppliers.

1   And the question of, well, what's their

2   demand going to look like for those upstream

3   licenses is very closely related to what they

4   anticipate their downstream market is going to

5   look like. So example, in the extreme, suppose

6   all of the listeners of a service were to

7   disappear from the face of the earth and all their

8   prospective listeners were to disappear from the

9   earth. It's not too far of a stretch of the

10   imagination to say that service's demand for

11   licenses is essentially going to go to zero. They

12   don't have a market to supply. Less extremely, if

13   that service is facing a downstream market that's

14   very, very price sensitive, that has lots of

15   competition within it, there are reasons to

16   believe that that competition can get fed back

17   upstream to the service's own demand for the

18   inputs that it is purchasing.

19   Q   Now, assuming that there is a very high

20   elasticity of demand in the downstream consumer

21   market, does it matter, as Professors Katz and

22   Shapiro claim, that the major labels may be

23   pricing as monopolists in the upstream licensing

24   market for interactive services?

25   A   Well, I mean, I guess the interesting

1 point here is that let's just suppose that they're

2 the only producers or that there's a -- say, a

3 single label that's the producer in the upstream

4 market. It might be technically, in a very

5 pedantic sense, a monopolist because it's the only

6 game in town. But if it is facing a demand that

7 is itself very price elastic, possibly because of

8 a downstream elasticity or price sensitivity in

9 its market, it's not going to be a monopolist

10 that's going to be able to do very much. It's not

11 going to be able to charge rates at an exorbitant

12 level because it realizes that its downstream --

13 that the downstream end users are going to flee if

14 those rates end up being passed on to them.

15   It's not going to be able to constrain

16 quantity the way that monopolists sometimes do,

17 but the type of dead weight loss -- I don't know

18 if you've seen some of these diagrams here, but

19 dead weight loss is associated with monopolies,

20 that's something that economists really care

21 about, and that degree of dead weight loss would

22 be actually quite small for a monopolist who is

23 facing a very, very elastic demand.

24   JUDGE STRICKLER: Even though the

25 monopolist was facing a very elastic demand

1   because it was a monopolist, it would still be

2   able to shift some of the intermediate market

3   consumer surplus all the way to producer surplus.

4   THE WITNESS: In the extreme, the answer

5   is actually no. If it were facing a completely

6   price elastic demand, it wouldn't be able to. So

7   the monopolist might be -- I mean, that's what

8   monopoly pricing is. But I think it's important

9   to understand that if you've got a monopolist that

10   is facing a demand curve that's extremely elastic,

11   it may be yet another one of these examples of,

12   okay, well, maybe technically this is a monopoly,

13   but it's not necessarily a monopoly that we should

14   have occasion to be excessively concerned about.

15   There are other examples as well. For

16   instance, companies that make very, very

17   high-quality services or products may end up

18   gaining very dominant positions in the market.

19   But it's not necessarily something that we should

20   be incredibly concerned about simply because it's

21   their investments in quality that have put them

22   there, and it's creating value for the market.

23   Similarly, and I guess it's in some ways

24   relevant here as well, the underlying market here,

25   it concerns markets for copyrights. Those are

1   state sanctioned monopolies over the expression of

2   an idea and, it's essentially there so as to

3   catalyze entrepreneurship, creativity, and the

4   growth of the useful arts. So it may just be

5   another example of a situation where, yes, this

6   may be, from a college sophomore Econ 101

7   perspective, a monopoly, but is it a monopoly that

8   we should be too concerned about? That seems

9   highly more dubious.

10   CHIEF JUDGE BARNETT: Is this a good

11   time to take a break?

12   MR. BLAVIN: Yes, Your Honor.

13   CHIEF JUDGE BARNETT: Okay. We will be

14   at recess for 15 minutes.

15   (A brief recess was taken.)

16   CHIEF JUDGE BARNETT: Please be seated.

17   I'm going to say this out loud because it feels

18   like a Tuesday when it's really Wednesday. We

19   will break promptly at 4:15 today.

20   Mr. Blavin.

21   MR. BLAVIN: Thank you.

22   BY MR. BLAVIN:

23   Q   Professor Talley, I think you had

24   covered the first point on this slide. If you

25   could please describe briefly what you were trying

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1 to capture in the second point that you have

2 listed here.

3   A   Yes. So this feeds into what might

4 cause a purchaser's demand to be extremely elastic

5 so that even if it were facing a single monopoly,

6 the monopoly wouldn't be able to extract much in

7 terms of monopoly rates. This has to do with

8 what's the demand that is being served by that

9 downstream market. One way that an intermediate

10 purchaser can itself exhibit extremely elastic

11 demand is if that downstream market that it serves

12 itself is very, very price sensitive and highly

13 elastic. That can essentially get upstreamed, as

14 it were, to the demand, or sometimes economists

15 refer to this as the derived demand of the

16 intermediate supplier for the purchases of its own

17 inputs.

18   Q   Thank you.

19   With respect to the first point you have

20 listed here, did you attempt to model that at all

21 in your structural simulations?

22   A   There are ways within the simulations to

23 replicate the idea of a, I guess, an elasticity

24 shock at the buyer level. So I did that in two

25 ways in the simulations. And this was essentially

1   to say, okay, we've got a distribution of buyer

2   and seller types.

3   In the simulations I used what is

4   essentially a three-dimensional bell curve, a

5   bivariate normal distribution, and said, well,

6   what would happen if suddenly under scenario one

7   the buyers in this market, their demand shifted

8   down by some figure. I think in this chart it's

9   half or a third of a standard deviation. And the

10   second is what would happen if buyers in this

11   market suddenly had valuations that were

12   70 percent of their valuation before.

13   Q   What effect did this have on the price

14   distributions that emerged?

15   A   Well, the price distributions that

16   emerged both went down. They shifted downward.

17   And they also became more compressed, which would

18   be systematically or, I guess, symptomatic, I

19   guess, of a more elastic demand curve.

20   Q   Now, with respect to the second point

21   listed here, is an elasticity shock in the

22   downstream market one way that elasticity shock

23   that you model may occur in the upstream market?

24   A   Yes, that's one way that that

25   intermediate producer might end up having an

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1 elastic demand for its own intermediate goods is

2 if it's facing a downstream market that suddenly

3 has become more elastic, more price sensitive.

4   Q   You're aware that Professor Shapiro has

5 responded to this point by saying that the

6 elasticity of demand in the upstream licensing

7 market does not necessarily mirror the elasticity

8 of demand that may exist in the downstream

9 consumer market, and he's made reference to the

10 Hicks-Marshall formula. Do you disagree with

11 that?

12   A   As a general matter of theory, I don't.

13 The Hicks-Marshall or Marshall-Hicks, depending on

14 who your favorite economist is, I guess, formula

15 does tell us a little bit about the conditions

16 under which a downstream market's price

17 sensitivity would get passed upstream to the

18 demand for an input. And under certain

19 circumstances, it can get passed very, very

20 frictionlessly upstream. And in some

21 circumstances it can be diverted or absorbed

22 elsewhere.

23   Q   So what are those circumstances or

24 factors that may exist that would be relevant to

25 that deformation?

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1   A   Sorry for starting too soon.

2   So the key two factors are, is there, in

3   fact, an elastic downstream demand curve. The

4   second is, how significant is the expenditure on

5   that input versus other inputs, right, the cost

6   intensity of that particular input that we're

7   interested in.

8   So if we're thinking about licenses in

9   this case, how -- how much of the overall variable

10   cost of this company is made up of having to

11   purchase licenses as opposed to other costs. The

12   larger that cost share, the more this elasticity

13   is going to be passed through. In contrast, very,

14   very small cost share inputs, things that you

15   don't spend much capital on at the input stages,

16   don't get passed through as much. That's one of

17   the core insights of Hicks-Marshall or

18   Marshall-Hicks. There's sometimes a saying that

19   goes with it that it's the significance of being

20   insignificant. If your insignificant has share of

21   the cost, then that elasticity is less likely to

22   be passed through.

23   JUDGE STRICKLER: How do you apply,

24   Professor, this concept of the downstream

25   elasticity affecting the upstream price in a

1   situation where you have what at least appears,

2   arguably, to be a two-sided platform in the

3   downstream market with regard to noninteractive

4   services, that is, many -- many people are

5   listening, their demand curve is a little funny

6   for us to apply because they don't pay anything,

7   it's free to them, and it's advertising supported

8   service.

9   So how, if at all, would your analysis

10   change given the fact that -- or let's assume the

11   fact that it's an ad-supported service we're

12   looking at rather than a subscription-based

13   service?

14   THE WITNESS: That's a great question.

15   So there are many ways that a price could be

16   visited on a consumer. One is you pay an

17   out-of-pocket price per hour on a subscription

18   basis. Ad-supported services can also alter the

19   price you're going to have to pay to listen to the

20   tune or to listen to this webcast from time to

21   time. The more the advertisements, the higher the

22   price; the less the advertisements, the lower the

23   price. So there's a type of an in-kind price

24   component that would be related to this type of

25   elasticity pass-through. But I agree with you, it

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1   would have to be -- it would have to be converted

2   possibly.

3   The other issue is that there are

4   certain types of alternatives at the downstream

5   level, like the cost of threat of piracy or other

6   outlets, YouTube, for example, that are also going

7   to give rise to high price elasticity even if you

8   started to charge a price rather than advertising.

9   In fact, that may be one of the reasons why it's

10 hard to charge a price simply because there are

11 these outside options that downstream listeners

12 have to resort possibly to pirated content.

13   JUDGE STRICKLER: Thank you.

14 BY MR. BLAVIN:

15   Q   Now, with respect to these factors you

16 just mentioned before, do you see them generally

17 in the market that we're looking at?

18   A   Well, from what I understand of this

19 market, the variable costs associated with

20 licenses is, in fact, a very significant cost

21 share of the cost of the services. And to the

22 extent, then, that the downstream market does

23 exhibit these types of high price elasticities,

24 this would be one conduit where you would expect

25 those elasticities, in fact, to be passed up to

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1   the demand for the input as opposed to less cost

2   intensive inputs.

3   Q   Now, given these factors, would you

4   expect the price that would emerge in the upstream

5   licensing market to be comparable to the price

6   that would result in what Professors Katz and

7   Shapiro have described as an effectively or

8   workably competitively market?

9   A   Well, I need to be careful here. I

10 haven't done an empirical analysis of that market,

11 but to the extent that the conditions are there,

12 and I think they are, for high elasticity

13 downstream markets to have that elasticity passed

14 up to the licensing market as a significant cost

15 share, I see a very strong tie between the

16 downstream market and the upstream market; and,

17 therefore, to the extent that downstream market is

18 also reflecting effective competition and

19 Professor Shapiro and Katz haven't really

20 precisely defined what they mean by "effective or

21 workable competition," then it would, in fact, be

22 passed back up to the demand for the inputs.

23   Q   Would that still be a monopoly rate in

24 the upstream market?

25   A   Again, I think we're back to this more

1 pedantic point that it may well be the only case

2 that you're the only game in town as a monopolist,

3 if you are a monopolist, but you're facing a very

4 elastic demand curve and your ability to utilize

5 that monopoly for things that we typically think

6 monopolies are -- are bad, it's going to be quite

7 limited.

8   Q   Now, with respect to your third

9 criticism, in what ways is Professor Katz and

10 Professor Shapiro's economic analysis of the

11 hypothetical market inconsistent with economic

12 theory?

13   A   Well, as I noted earlier, Professor Katz

14 and Shapiro don't really adopt a type of a

15 buyer/seller framework. They end up using some

16 more conventional, you know, sort of textbook

17 accounts of the markets for widgets from a sort of

18 an elementary economics class, which is fine, but

19 it does omit, I think, important things that are

20 related to this particular setting.

21   The first that I note about both of them

22 is their omission of fixed costs as a considerable

23 component of costs. I agree with them that

24 there's a large fixed cost component or quasi

25 fixed cost component to this industry, but if

1   that's the case, then pricing conditions in this

2   industry need to be attentive to fixed costs.

3   So, for example, Professor Shapiro is

4   quite fond of invoking the Lerner equation, which

5   is essentially a way of -- you know, it's

6   essentially a marginal cost pricing condition that

7   relates the elasticity of demand to your

8   price-cost markup. Well, that's essentially

9   assuming that the fixed costs are recovered

10   through operations anyway. If those fixed costs

11   are not recovered, then that company, if it priced

12   at the Lerner equation level, would be operating

13   at a loss and it would not be able to sustain it.

14   So the Lerner equation is true only insofar as the

15   company is able to recover and, therefore, ignore

16   its fixed and quasi fixed costs.

17   JUDGE STRICKLER: Assuming, then, that

18   the Lerner equation does not apply, given the

19   existence of those fixed costs and the declining

20   or marginal costs would be a zero marginal cost

21   for an incremental play, how, in such a market,

22   does the willing seller recover its fixed costs?

23   THE WITNESS: Yes, so just one fine

24   point. So there may be -- I think this has been

25   touched on before. There may be elements of

1 opportunity costs, as well, that are part of

2 marginal costs that cause a diverge to -- diverge

3 from, say, zero.

4   But to the extent we stick with that

5 hypothetical, a supplier in that market is not

6 going to stay in the market unless it can recover

7 what is essentially its average costs. So at the

8 end of the day, you know, that supplier has got to

9 be able to recover its fixed costs, essentially an

10 average cost with a reasonable return type of

11 pricing scheme.

12   JUDGE STRICKLER: How does such a

13 willing seller recover its fixed costs given that

14 it has to do that? How does it price?

15   THE WITNESS: Yes. So it's going to

16 price -- so in the framework that I've set up,

17 it's going to be pricing by negotiation with

18 individual buyers, and the seller's willingness to

19 accept may very well be -- one of the things it

20 informs -- and this gets back to our discussion

21 earlier about, you know, what goes into that

22 willingness to accept, that may be that I need to

23 meet my average cost constraints. Fixed cost

24 recovery may be the point where, look, this is not

25 going to be a worthwhile deal for me. And that

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1 may inform that seller's -- that seller's

2 bargaining or willingness to enter a deal at a

3 lower rate.

4   JUDGE STRICKLER: Would a willing seller

5 look to differing willingnesses, if you will, to

6 accept among different buyers and establish

7 different prices with regard to its individual

8 intermediate parts?

9   THE WITNESS: One thing to remember

10 about this market as opposed to -- the answer, by

11 the way, is it seems likely that they might, as

12 the buyers might as well. One thing to remember

13 in this market, unlike the market for widgets,

14 where I sell Mr. Blavin a widget and I sell you

15 another widget at a lower price, that widget

16 market may have a lot of secondary trades going

17 inside it.

18   JUDGE STRICKLER: Selling might be

19 different.

20   THE WITNESS: Yes, you might just become

21 an intermediate supplier of widgets.

22   In IP markets where there are

23 restrictions on assignment or transfer of

24 licenses, you don't have to worry about that as

25 much. So you can have a differential distribution

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1   of prices. In fact, that's, in some ways, my

2   third bullet point here, that you would expect in

3   these markets to see that type of price

4   distribution based on the deals that are struck

5   between buyers and sellers, possibly with

6   differential bargaining power across those deals.

7   JUDGE STRICKLER: Would Ramsey pricing,

8   that is, pricing based on the elasticity of demand

9   of the willing buyer, the various willing buyers,

10   be applied in order to try to recover fixed costs?

11   THE WITNESS: It could be applied. But,

12   remember, one of the things that's at issue here

13   is whether this is a price-taking type of demand

14   side of the market, right? So Ramsey pricing is a

15   type of pricing formula that says I set my price

16   and I'm going to set them -- you know,

17   essentially, there's a condition on Ramsey pricing

18   on -- across different segments of the market --

19   and I'll be able to maximize my profits that way.

20   But that assumes a type of price-taking

21   behavior. That may not be what's at issue here.

22   I'm not convinced that that's what's foreshadowed

23   by the willing buyer and willing seller framework,

24   that this may be much more -- that's why I ended

25   up using a structural model, where you've got

1 individual transactions being negotiated between

2 willing buyers and willing sellers.

3   JUDGE STRICKLER: Can't you have Ramsey

4 pricing even without reducing buyers to be price

5 takers because there could be negotiations where

6 there's a determination of what the buyer's

7 willingness to pay is, and the seller has its

8 willingness to accept, and, in those negotiations,

9 each buyer comes out with its own result that

10 either -- that is no lower than its willingness to

11 pay?

12   THE WITNESS: Yes.

13   JUDGE STRICKLER: Excuse me, no higher

14 than its willingness to pay, but each one varies.

15   THE WITNESS: I'm sorry I interrupted

16 you. So that's certainly a possibility here. I

17 think Professor Katz talked about this a little

18 bit yesterday, that there may be interactions

19 between the buyer and seller in which they learn

20 about each other's willingness to pay and

21 willingness to accept, and at that point the

22 seller might think, okay, I'm going to try to get

23 as much of that buyer's willingness to pay as

24 possible. The buyer is probably, if the buyer is

25 a rational agent, thinking, I'm going to try to

1   get as much of the seller's surplus as possible.

2   And at that point we've set up a bargaining

3   problem, right, in which there's going to be some

4   division of surplus between them. If the seller

5   has all the bargaining power, that would be a type

6   of price discrimination.

7   JUDGE STRICKLER: Thank you.

8   BY MR. BLAVIN:

9   Q   I think through that back-and-forth you

10 covered all of the points here, but if I'm wrong,

11 let me know?

12   CHIEF JUDGE BARNETT: May I ask a

13 question.

14   THE WITNESS: Sure.

15   CHIEF JUDGE BARNETT: By the way,

16 speaking of division of surplus, let's have a

17 moment of silence for Professor Nash. This is not

18 a widget industry. This is a creative industry.

19 If the record -- major record labels have costs,

20 fixed costs that they have to recover and they

21 decide they're not recovering them for whatever

22 reason, it's not going to stop music, right? I

23 mean, I could go record on YouTube if I could

24 carry a tune. Any artist could record in their

25 garage and deliver an MP3 to a terrestrial radio

1   station and become a star without 6 billion

2   dollars in A&R costs being sunk.

3   So if the -- I just -- I have trouble

4   with the concept of having to recover fixed costs

5   in this industry when, you know, it's not -- it's

6   not completely open to entry. On the other hand,

7   these days, it's not completely restricted to

8   entry either, and why wouldn't they just reduce

9   their costs? I guess that's the point.

10   THE WITNESS: So that's a loaded

11   question, but it's a perfectly good question. By

12   the way, thank you for acknowledging the passing

13   of John Nash. He's been a very important figure

14   in economics.

15   So within any industry, one can imagine

16   that expertise is built up in not only in finding

17   talent, which can be quite difficult, promoting

18   talent, assembling talent, recording with high

19   quality rather than garage-level recording. And

20   these are all components of what are essentially

21   recurring or quasi fixed costs.

22   It may well be the case -- in fact, it

23   probably is the case already, there's a segment of

24   the music industry, broadly defined, in which

25   people are recording things in their bedroom and

1 posting it on YouTube. But there is another

2 segment that seems to have quite high value among

3 consumers in which some of these areas of

4 expertise are, in fact, quite valuable. So if the

5 labels aren't able to recover their fixed costs,

6 do they go out of business?

7   Maybe in the extreme they would, but

8 they would certainly dial back those fixed costs,

9 and that would give rise to fewer investments in

10 the development, the assembly, the recording, the

11 promotion of some of these talents that presumably

12 are viewed as quite attractive to the public.

13   You back up even further and ask, well,

14 how does this affect my investment in deciding to

15 become a classical guitarist, which I almost did,

16 and versus going to a Ph.D. program in economics?

17 Then that can also have feedback effects, right?

18 That's, in some ways, just a microcosm or a

19 macrocosm of the idea of why intellectual property

20 rights have value.

21   So I think I get your point, and I agree

22 with it so far, but to the extent that this is a

23 segment of the music industry that involves

24 particular skills and particular investments that

25 are really hard to assemble, I don't think you

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1   replicate that by sitting in your garage.

2   CHIEF JUDGE BARNETT: Thank you.

3   BY MR. BLAVIN:

4   Q   So with respect to your final point,

5   Professor Katz and Professor Shapiro maintain that

6   the interactive set of agreements are not proper

7   benchmarks here because the major labels are

8   must-haves in the interactive space and that the

9   bargaining dynamic that would give rise to those

10   agreements is inappropriate for setting the

11   statutory rate in the noninteractive space.

12   Do you believe that the bargaining

13   dynamics that exist in the interactive space would

14   not also exist in the noninteractive space?

15   A   So I don't find that distinction

16   particularly compelling for a couple different

17   reasons. The first is that to the extent that the

18   labels, the majors, are must-haves in the

19   interactive market, I don't see much of a reason

20   to believe that they're any less must-haves in the

21   noninteractive market. I think multiple times in

22   his testimony or deposition, Professor Katz

23   himself has conceded this. Professor Shapiro

24   adverts to -- through his steering experiment

25   arguments to a claim that maybe the majors aren't

1 must-haves in the noninteractive market because,

2 according to him, Pandora was able successfully to

3 steer away from major label catalogs. But even

4 that steering experiment is not quite the

5 experiment that you would want to determine

6 whether the label was a must-have.

7   In none of the McBride and Shapiro

8 experiments, at least that I'm aware of, was

9 steering experimented with to the point of

10 100 percent, which is really the threat that you

11 would have to be making, we're going to drop your

12 label entirely. Moreover, it's -- from, I think,

13 both versions of these experiments, one sees that

14 listenership starts to fall off at 30 percent

15 levels or even before that and, I think, in

16 another one of the experiments, when steering away

17 from a major.

18   So the steering experiments don't quite,

19 I don't think, give you what you need to determine

20 that the majors are not must-haves in the

21 interactive -- in the noninteractive market any

22 more than they are in the interactive market.

23 Moreover, as I mentioned in my report, Professor

24 Shapiro did not conduct a similarly situated horse

25 race in the interactive market. If one were

1 interested in trying to get the extent to which

2 there was steering possibilities between the two,

3 or differences, I would want to see an

4 apples-to-apples comparison.

5   And then, finally, you know, there's

6 this point that's come up a few times,

7 particularly in the context of the Merlin-Pandora

8 deal, that steering -- an affirmative obligation

9 to steer just can't be implemented on a

10 market-wide basis. It's just not possible for a

11 service to say I'm going to steer listenership

12 towards each label that I contract with. Whenever

13 you steer toward one label, you have to be

14 steering away from someone else. And, therefore,

15 it's almost like a Lake Wobegon effect, that not

16 everyone can be above average, not everyone can

17 receive steering.

18   JUDGE STRICKLER: But isn't it the case

19 that a service, a noninteractive service can

20 threaten to steer to each of the majors, leaving

21 the independents out for the moment, and each

22 major would then have to, in bargaining theory,

23 have to determine, do I want to hold fast and not

24 cut my rate in the hopes of getting more -- and if

25 I don't cut and one or both of the other majors do

1 cut, now I will lose the market because they

2 recognize, just as you do, that you can't -- you

3 can't have more than 100 percent of the music

4 played?

5   So, as a consequence, steering can be a

6 threat. I believe Dr. Shapiro said, therefore,

7 once you have the opportunity to steer, you might

8 actually see no steering at all because everyone

9 would bid -- you can almost think of it, perhaps,

10 as an auction. I want your best deal by midnight

11 on Friday, and then I'll decide whether or not, if

12 I'm Pandora, to whom I'm going to steer more and

13 to whom I'm going to steer less, then everybody

14 has to scratch their heads and hopefully not

15 explicitly collude and decide what it is that they

16 want to do. Isn't that dynamic of steering

17 sufficient to influence price?

18   MR. BLAVIN: I think this is the next

19 slide so we can move to that.

20   JUDGE STRICKLER: But I can't wait.

21   MR. BLAVIN: We're right here. We're

22 there.

23   THE WITNESS: You need not wait.

24 Just-in-time delivery, okay?

25   So, yes, so I'm aware -- I cuddled up

1 with Dr. Shapiro's trial testimony transcript a

2 few nights ago and saw that he went through this.

3 It was probably not the best reading option that I

4 had for the evening --

5   JUDGE STRICKLER: We won't tell him.

6   THE WITNESS: -- but I went through it

7 nonetheless. And he makes this argument. Another

8 sort of econo head way to put this is that the

9 threat to steer away would be an off-equilibrium

10 threat. You make the threat and you wouldn't have

11 to follow through on it.

12   Now, one thing that's really incredibly

13 important if -- it's conceivable that a threat

14 that you don't have to follow through on could

15 have price effects, but there are a couple things

16 that have to be present before that's true. First

17 of all, it has to be a credible threat. You have

18 to be able to say, look, I am -- you know, if your

19 bluff gets called and you don't negotiate a lower

20 rate, then they're going to have to turn around

21 and actually start steering against you.

22   It appears from the margins that we see,

23 at least in those McBride-Shapiro experiments that

24 at some point you're not going to be able to do

25 that at 100 percent. At some point listenership

1   is going to fall off a lot.

2   JUDGE STRICKLER: Then you're in

3   agreement with Professor Shapiro in that regard

4   because he doesn't say you can steer 100 percent

5   away. He's relying on Dr. McBride's studies where

6   the majors, so they claim, 15 percent, no effect;

7   30 percent, perhaps you're starting to see a

8   falloff. So no one is claiming -- it seems like

9   the criticism that you can't steer 100 percent

10 away from a label is a bit of a straw man argument

11 because nobody is addressing that.

12   THE WITNESS: Good point. So let me

13 turn the tables a little bit. So suppose that I

14 were negotiating, let's say, a service like

15 Pandora, and the threat was, we're going to steer

16 away from you at 25 percent, and we're willing to

17 bear the cost to do it.

18   JUDGE STRICKLER: Who's the "we" now?

19 Pandora?

20   THE WITNESS: Excuse me, Pandora. We're

21 willing to bear the cost to do it.

22   JUDGE STRICKLER: So I understand your

23 hypothetical, what costs would they be bearing?

24   THE WITNESS: So the cost of, say,

25 falloff of listenership if they start steering.

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1   JUDGE STRICKLER: So we're assuming in

2   this hypothetical a falloff of listenership at

3   25 percent, steering away from, say, Sony, for

4   example.

5   THE WITNESS: Exactly.

6   So a couple issues that may come into

7   play here. We don't know for sure whether the

8   threat to steer, if carried out, and then

9   publicized, would, in fact, have the same

10 repercussions as in the Pandora experiment. So

11 one thing that's critical about the Pandora

12 experiment is the end users. They weren't aware

13 that they were steering against. To the extent

14 that the end users are informed -- and I can tell

15 you a major label might have an incentive to start

16 informing users that this is happening -- then

17 that could be a problem.

18   Second, think about this in the

19 hypothetical market where there is no background

20 statutory rate. That label might say, okay, if

21 you're going to do that, we may just walk away,

22 right? We can force you to steer away from us at

23 100 percent.

24   JUDGE STRICKLER: That's a function of

25 the major's market power, the ability to walk

1   away, right?

2   THE WITNESS: It might be. But

3   Professor Shapiro has talked about steering

4   ability as a credible threat. I think that's part

5   of the question of credibility. I think the last

6   two points that are particularly important is that

7   in the context that we sit today, when a provider

8   like Pandora says, well, we're going to threaten

9   to steer against you, there is essentially a

10   safety net that they are working with, all right?

11   If I steer against a particular major and I'm

12   worried, well, they're going to take it out of me

13   when I negotiate a license with them or they're

14   going to refuse to license to me, I actually have

15   the safety net of the statutory license in the

16   background.

17   So to the extent that that safety net is

18   providing the type of ammunition to threaten to

19   steer against, I can always get the majors on the

20   statutory license, then that probably shouldn't be

21   what we're considering when we consider the

22   hypothetical market in the absence --

23   JUDGE STRICKLER: I was just going to

24   say, we're talking about the hypothetical market.

25   THE WITNESS: Right.

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 1            JUDGE STRICKLER:  In a situation like

 2  that, the only way that Sony could say you're only

 3  going to place my music at 75 percent of the rate

 4  that you usually played it before, I'm taking --

 5  the expression I used before with someone else --

 6  taking my bat and ball and I'm going home and

 7  you're not getting any of my music.  They can

 8  afford to do that because they have a large

 9  segment of the market.  By contrast, an

10  independent might not have the same ability to do

11  that because it would harm them more.

12            THE WITNESS:  Well, once again, I'm

13  responding to Professor Shapiro's assertion, which

14  I'm not convinced of, that this steering threat is

15  going at the end of the day going to be a credible

16  threat and that the noninteractive market is any

17  different than the interactive market.  So to the

18  extent that this is a plausible line of reasoning,

19  which I think it might be, I think that's another

20  reason to think that the interactive and

21  noninteractive markets just may not be that

22  different from one another.

23            Then the last point is that the

24  negotiated transaction that Professor Shapiro has

25  proffered is, in fact, not one of these
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1   transactions that is either negotiated in the

2   shadow of a threat to steer away or negotiated

3   with an undertaking to steer away. It's in the

4   opposite direction. This is a promise, in fact, a

5   contractual obligation to steer towards Merlin as

6   opposed to away from Merlin. Not only does that

7   give rise again to this question of the Lake

8   Wobegon effect, but the steering obligations, the

9   guaranties and other aspects of that deal would

10   also be something that presumably would be of

11   value.

12   I know there's some dispute about

13   whether Professor Shapiro has valued them

14   appropriately, but they would seem to have some

15   value, some option value, some insurance value,

16   and that could be animating part of the lower

17   price that Merlin has negotiated.

18   JUDGE STRICKLER: You mentioned before

19   something very particularly interesting, and that

20   was that if Sony, for example, was played less

21   pursuant to some sort of steering strategy by

22   Pandora, it would not necessarily sit back quietly

23   and allow that to happen, and other services that

24   might not be doing it, along with Sony, would be

25   happy to broadcast the fact you're not getting the

1 music you want, you're getting music they can

2 afford or words to that effect.

3   What I was struck by is that when we

4 talk about steering, that door is always open. We

5 never go into closed session. It was never

6 considered confidential. Pandora is always happy

7 to speak out loud about this steering. So,

8 presumably, they're not particularly concerned

9 about the repercussions because they're happy to

10 make it open and notorious that the steering is

11 occurring, presumably, along with, assuming the

12 strategy works and they can get overall lower

13 rates, they could pass that along to, well, to the

14 small group of people who subscribe at lower rates

15 or charge less for advertising or play fewer

16 advertisements, enhance their listenership.

17   So doesn't it seem like, it might not be

18 correct, it's a rational business strategy to

19 undertake?

20   THE WITNESS: It's a fair point to make.

21 One thing I will note, however, is that the

22 steering experiments that Dr. McBride and

23 Professor Shapiro talked about were randomized,

24 single-blinded experiments. So it may be possible

25 to learn that some steering is going on for six

1 weeks or -- 13 weeks, but not necessarily know

2 whether it's going to be something that -- am I

3 part of the treatment group, am I a part of the

4 placebo group of this experiment. So I think

5 that's a little bit different than a business

6 undertaking that we are systematically steered

7 away.

8   Now, to be sure, when you're facing

9 differential prices, that can have an effect on

10 utilization. But the steering experiments

11 themselves, I think it's sort of critical that the

12 public didn't know about it, at least at that

13 level, at that degree of granularity.

14   JUDGE STRICKLER: Thank you.

15 BY MR. BLAVIN:

16   Q   Now, if Pandora threatened to steer

17 against a label like Sony, would it matter what

18 other options were available to the label to reach

19 those same listeners?

20   A   Yes, I think that we talked a little bit

21 about this before, but one option open to the

22 label potentially would be to say, okay, we're

23 going to sponsor another noninteractive service or

24 join forces with another noninteractive service

25 that is going to be in a position not to threaten

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1   to steer. So that may also undermine the

2   credibility of the steering threat.

3   MR. BLAVIN: Thank you. No further

4   questions.

5   CHIEF JUDGE BARNETT: Thank you.

6   Mr. Ebin.

7   MR. EBIN: Would you like me to start?

8   CHIEF JUDGE BARNETT: Yes.

9   MR. EBIN: We have a few -- just one

10 binder.

11   CROSS-EXAMINATION BY COUNSEL FOR PANDORA

12 BY MR. EBIN:

13   Q   Good morning, Professor Talley. Barely.

14   A   Good morning, barely.

15   Q   Nice to see you again.

16   A   Nice to see you, Mr. Ebin.

17   Q   As I know you know, I'm Jacob Ebin. I'm

18 representing Pandora Media in this proceeding. I

19 would like to begin by exploring some of the

20 factual foundation for the opinions you offer in

21 your written rebuttal testimony.

22   In the course of preparing your written

23 rebuttal testimony, you never spoke with anyone at

24 SoundExchange, correct?

25   A   I did not.

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1   Q   And you never spoke with anyone at a

2 record label, correct?

3   A   Not in the context of this retention.

4   Q   And also in the course of preparing your

5 written rebuttal testimony, you never spoke with

6 anyone at an interactive service.

7   A   I did not.

8   Q   And you never spoke with anyone at a

9 noninteractive service, correct?

10   A   That's correct.

11   Q   Now, the entirety of the materials you

12 relied upon in preparing your written rebuttal

13 testimony are either specifically referenced in

14 your written testimony or listed in the materials

15 relied upon list that you have at the back of your

16 testimony, correct?

17   A   I believe so, yes. Yes.

18   Q   That's what you testified to at your

19 deposition.

20   A   Yes, I believe so.

21   Q   Let's take a look at that materials

22 relied upon list. It's at the very back of your

23 testimony at the pages SX 19-88 through 91. It

24 should be in that cross binder behind the tab SX

25 Exhibit 19, all the way at the back of that.

1   A   Okay, yes.

2   Q   Are you with me?

3   Now, let's start with this first section

4   here which you labeled as CRB materials.

5   A   Yes.

6   Q   Now, you would agree with me that only

7   two of the list of documents in this section are

8   from this proceeding, correct?

9   A   I believe that's correct, yes.

10   Q   One of those is the order dismissing the

11   petition to participate of Triton Digital?

12   A   I believe that's correct, yes.

13   Q   The other, as you clarified in the

14   errata sheet to your deposition, the notice

15   announcing commencement of this proceeding,

16   correct?

17   A   I believe that's right, yes.

18   Q   But at the time of your deposition, you

19   weren't able to identify what that document was,

20   were you?

21   A   I think it was -- the reference to it

22   was unclear, but we clarified -- checked and

23   clarified it, yes.

24   Q   But when you were asked at your

25   deposition what that document was, you were not

1   able to identify it.

2   A   Someone asked me what this document was

3   off of this list and I couldn't remember which one

4   in particular it was.

5   Q   Right.

6   And the remainder of the documents

7   listed in your materials relied upon list included

8   an academic book, some academic articles and

9   handful of online articles from Tech Crunch,

10   Digital Music News, MacRumors, CNET, and Time, and

11   then a few statutes, and the closing statement

12   from the FTC regarding its review of Universal's

13   acquisition of EMI; is that right?

14   A   That appears to be right, yes.

15   Q   So there's not a single item in your

16   materials relied upon list that was produced by

17   any party in this proceeding, correct?

18   A   Well, I have reviewed the reports of

19   Professors Shapiro and Katz. Those are discussed

20   at length.

21   Q   But not a single document produced as

22   part of the discovery in this proceeding.

23   A   Well, to the extent -- that's not

24   necessarily the case because Professor Shapiro and

25   Katz had items associated with discovery that I

1 was reviewing as well.

2   Q   Putting to one side their actual

3 testimony, there's not a single item in this

4 materials relied upon list that was produced in

5 discovery in this proceeding, is there?

6   A   Well, so let me be -- so in reading

7 various depositions --

8   Q   Professor, I'm sorry, I'm just focused

9 on the materials relied upon list.

10   A   I get it.

11   Q   There was not a single document that was

12 produced in discovery in this case that's listed

13 on this list.

14   A   In this list, that's correct.

15   Q   Now let's turn to the documents you

16 reference in your written rebuttal testimony.

17 Other than the actual written testimony that

18 you've reviewed, the only documents produced in

19 this proceeding that you reference are the

20 Pandora-Merlin agreement and a single chart

21 showing the results of an early steering

22 experiment conducted by Pandora, correct?

23   A   You know, if you want to point out

24 places, that's fine.

25   Q   I can represent to you that I looked and

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1   a colleague of mine looked and we are not able to

2   identify a single other document produced in this

3   proceeding other than the two that I just

4   mentioned.

5   A   So are you -- so you're cabining again,

6   say, the expert reports of Professor Shapiro,

7   Katz, the experts.

8   Q   Professor Shapiro and the Katz testimony

9   and the McBride testimony.

10   A   And the appendices to those that are, in

11   many cases, quite copious.

12   Q   Yes, putting to one side the actual

13   pieces of testimony you reviewed, the other

14   discovery materials, the only thing that you

15   reference in your report are the Pandora-Merlin

16   agreement and the single chart showing the results

17   of an early steering experiment, correct?

18   A   So I will take your representation. One

19   thing we discussed I think in the deposition is

20   there were later contracts that were made

21   available that I also reviewed, the Apple

22   contracts, the Pandora-Merlin agreement.

23   Q   You reviewed those Apple contracts,

24   though, after your written rebuttal testimony was

25   submitted.

1   A   That's correct.

2   Q   I'm just questioning you on what's in

3 your written rebuttal testimony.

4   A   Right.

5   Q   In preparing your written rebuttal

6 testimony, you did not examine any of the

7 agreements between interactive services and record

8 labels, did you?

9   A   Once again, I reviewed the other expert

10 reports, but -- and to the extent that those

11 expert reports engaged with them, I picked up from

12 those reports and appended to them some of those

13 pieces of information.

14   Q   You didn't look at the actual agreements

15 themselves, correct?

16   A   I'm not sure about that one way or the

17 other. I'm trying -- I can't remember whether

18 they were appended to -- I have seen them. I've

19 gone through many of them, but I can't remember

20 whether they were at the time I wrote this report

21 appended to Professor Shapiro's report or not.

22   Q   Let's take a look at your deposition.

23 That's the first tab in your binder there.

24   A   Sure.

25   Q   Turn to page 139.

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1   A   All right.

2   Q   Do you see at line 16 -- I'm sorry, I'll

3 give the judge a moment to catch up. I apologize

4 for going too quickly.

5   JUDGE STRICKLER: Thank you.

6   Q   Do you see at line 16 on page 139,

7 question, "Have you looked at the economic terms

8 of any of the contracts negotiated between

9 interactive services and record labels?"

10   Answer, "I believe I've seen summaries

11 of them. I haven't, sort of, gone through the

12 contract terms in the way that I have with a

13 couple of noninteractives."

14   Did you give that testimony at your

15 deposition?

16   A   Yes, I did, but notice the exposure I

17 had to those was also through Professor

18 Rubinfeld's extensive own report.

19   Q   I believe you then clarified that you

20 looked at summaries of the economic terms as

21 prepared by Professor Rubinfeld, correct?

22   A   The descriptions and appendices of his

23 report.

24   Q   Again at your deposition you were not

25 able to name a single interactive service other

1 than Spotify, correct?

2   A   You know, I think that I can't remember

3 one way or another.

4   Q   We can take a look.

5   A   Okay.

6   Q   Turn to page 70 of your deposition.

7 This is line 11.

8   A   All right.

9   Q   Question, "Can you name any interactive

10 webcasting services?" Answer, "I think Spotify

11 is, you know, it's got a version. It's got a

12 platform that's an interactive platform."

13   "Can you name any others?"

14   Answer, "I think that there are others.

15 I think that, you know, there are many that have

16 multiple platforms, but I didn't do an inventory.

17 I think I've seen a list of them."

18   Question, "As you sit here today, can

19 you name any other webcasting services other than

20 Spotify?"

21   Answer, "I think that there would be

22 others, but I would have to look to documents that

23 I was reviewing."

24   Did you give that testimony at your

25 deposition?

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1   A   I did.

2   Q   You also, in your preparation for your

3 written rebuttal testimony, did not review the

4 agreements between iHeartMedia and record labels,

5 correct?

6   A   Once again, I reviewed the report of

7 Professors Fischel and Lichtman. There was an

8 extensive analysis of those contracts.

9   Q   But you didn't look at the contracts

10 themselves, correct?

11   A   I can't remember whether they were

12 appended or not at the time.

13   Q   And the only noninteractive webcasters

14 that you were able to name at your deposition

15 until prompted by Mr. Joseph were Pandora and

16 iHeartRadio, correct?

17   A   I assume if you'll so stipulate, sure.

18   Q   While you did look at the Pandora-Merlin

19 agreement, you didn't spend any time reviewing the

20 documents memorializing any of the negotiations

21 between Pandora and Merlin, did you?

22   A   Once again, I definitely came across

23 discussions, reports of them. I don't believe --

24 I don't know whether I reviewed them at the time.

25 I think, again, the same stipulation as before.

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1   Q   To save some time.

2   A   Right.

3   Q   More generally, you did not review any

4 documents memorializing the negotiations between

5 record labels or record collectives in any

6 streaming services, correct?

7   A   Again, same stipulation, I think.

8   Q   Let's take a look at what you said in

9 your deposition on this.

10   A   Sure.

11   Q   I'm at page 288, line 5. Are you with

12 me?

13   A   Uh-hmm.

14   Q   Question --

15   A   Excuse me. Yes.

16   Q   -- from Mr. Huppert, "Did you review any

17 evidence associated with the negotiations

18 surrounding any of the agreements that have been

19 proposed as benchmarks in this proceeding?"

20 Mr. Choudhury objected.

21   Answer, "Yes, I think that, you know,

22 certainly I have seen documents related to those

23 negotiations, but I have not taken any appreciable

24 time, if time at all, sort of, looking through

25 negotiation documents, drafts of letters, markups

1 of letters, strategy documents and things like

2 that."

3   Question, "So just to be clear, you have

4 not reviewed those kinds of documents that you

5 just listed?" Another objection from

6 Mr. Choudhury.

7   Answer, "Yes, so I have definitely, sort

8 of, reviewed the records that I have seen. There

9 have been some reference to those sorts of

10 negotiations. Certainly I have seen some of those

11 references, but I have not taken a close view at

12 negotiating documents in this case."

13   Is that the testimony you gave?

14   A   Yes, but remember the nature --

15   Q   Is that the deposition testimony you

16 gave?

17   A   Well, I'm trying to answer your

18 question, Mr. Ebin.

19   Q   It seems like a yes or no question.

20   A   It is the deposition testimony that I

21 gave, but there is a caveat.

22   Q   The answer to my question, then, is yes.

23 Your counsel will have an opportunity to follow up

24 with you if he thinks it's appropriate.

25   Now, in your discussion with Mr. Blavin

1 earlier today, you discussed how downstream

2 competition might impact rates negotiated between

3 interactive services and labels in the upstream

4 market. Do you recall that?

5   A   I do.

6   Q   You have done no empirical analysis to

7 ascertain whether and the degree to which that

8 downstream competition is, in fact, impacting the

9 upstream negotiations, have you?

10   A   Can you repeat that question, sir?

11   Q   You have done no empirical analysis to

12 ascertain whether and the degree to which that

13 downstream competition is, in fact, impacting the

14 upstream negotiations, have you?

15   A   So as I noted to you, I think, in the

16 deposition, my remit as an expert in this case is

17 as a rebuttal to Professor Shapiro. My criticism

18 of him is that he has not done that -- one of my

19 criticisms is that he has not done that either and

20 yet purports to make claims about the market

21 structure of the upstream market.

22   Q   Just answer my question, you have not

23 done any empirical analysis, correct?

24   A   I have criticized Professor Shapiro for

25 not doing it himself. I have not offered an

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1   affirmative suggested rate and, therefore, my

2   criticism of Professor Shapiro stands as is, yes.

3   Q   You have not attempted in your written

4   rebuttal testimony to calculate any elasticity of

5   demand whatsoever, have you?

6   A   I will give the same answer I did to

7   your last question, I was a rebuttal expert to

8   Professor Katz and Shapiro who themselves were not

9   trying to or did not attempt to compare

10   elasticity, and not withstanding the fact that the

11   Lerner equation was so central to the analysis of

12   Professor Shapiro. So I was brought in as an

13   expert rebuttal witness and I rebutted what I saw.

14   Q   So the answer to my question is no, you

15   have not done any empirical analysis?

16   A   Again, within the ambit of how I was

17   retained as an expert, I did not view that as part

18   of my charge.

19   Q   You have not undertaken any

20   investigation of the major record labels and how

21   they've acquired and exercised their potential

22   monopoly power so as to be in any position to

23   conclude that what we observe is a "sophomore Econ

24   101 perspective of monopoly," have you?

25   A   Well, that's not entirely the case. I

6094

1   do did teach mergers and acquisitions, and those

2   deals, in fact, are part of the cannon of that

3   class. So it's -- so for the purposes

4   specifically for this retention, the Universal/EMI

5   closing documents are part of what my listed

6   documents are, so that's not entirely true there

7   either. But it's essentially part of the job of

8   teaching in a class like that, to study

9   acquisitions.

10   Q   So the sole basis from this proceeding

11 that you relied on to conclude what you did in

12 your colloquy with, I believe, Judge Strickler

13 earlier was the closing statement from the FTC?

14   A   That's incorrect, Mr. Ebin. What I'm

15 relying on, along with all these other things, is

16 my experience as an academic and researcher in

17 this field and professor in this field.

18   Q   In your discussion earlier with Judge

19 Strickler, you mentioned that you would want to

20 know how many buyer/seller payers, I think your

21 word is dyads, actually availed themselves of the

22 Web II rates, correct?

23   A   That would be one of the pieces of

24 information that would be interesting.

25   Q   Are you aware of what the judges, in

6095

1 fact, concluded on this topic in the Web III

2 Remand decision?

3   A   I've read the Web III Remand decision.

4   Q   Nothing comes to mind as to what the

5 actual conclusion is?

6   A   You might want to refresh my memory.

7   Q   We can take a look at it on our lunch

8 break.

9   MR. EBIN: Actually, Your Honors, I'm

10 changing topics now if you would like to take a

11 break for lunch or if you'd like me to continue.

12   CHIEF JUDGE BARNETT: Oh, it's

13 lunchtime. I'm so fascinated by all of this

14 testimony. We'll be at recess for an hour.

15   (A lunch recess was taken.)

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1   AFTERNOON SESSION commencing at 1:08 p.m.

2   CHIEF JUDGE BARNETT: Good afternoon.

3   Please be seated.

4   You may continue, Mr. Ebin.

5   MR. EBIN: Good afternoon.

6   BY MR. EBIN:

7   Q   Good afternoon.

8   A   Good afternoon.

9   Q   Let's talk about your model.   To run the

10   simulations in your written rebuttal testimony,

11   you need to come up with numbers for what you term

12   as the five critical parameters; is that correct?

13   A   Let me back up a little bit.   For the

14   structural analysis, there were two parts.   There

15   was an analytic part and then an illustration

16   through the simulation.

17   Q   My question is to run the simulations

18   you presented in your written rebuttal testimony,

19   you needed to come up with numbers for your five

20   critical parameters, correct?

21   A   The simulation portion, in order to do a

22   simulation, it has to make an assumption about a

23   parametric environment.   In my case, I made that

24   assumption about the bivariate normal that has

25   five parameters, correct.

6097

1   Q   So the answer to my question was yes,

2 correct?

3   A   I believe the answer is yes.

4   Q   The numbers you used for those five

5 critical parameters are listed in your

6 footnote 74?

7   A   I believe so.

8   Q   I see.

9   Now, ideally, you would like to estimate

10 these five critical parameters from observed

11 real-world data, correct?

12   A   It would depend on what you were going

13 to use them all for. In my case I was using them

14 to critique Professors Katz and Shapiro.

15   Q   So it was your view you did not need any

16 real-world data and it would not be useful at all?

17   A   Like I said, Mr. Ebin, it would depend

18 on what one was trying to use the underlying model

19 for. If it were to point out what was a

20 conceptual flaw in the reasoning of Professors

21 Shapiro and Katz, that reasoning or that flaw

22 might emerge naturally without doing any

23 calibration at all. In some circumstances --

24 that's actually what happened here. In some

25 circumstances, the question is more complex and

1 you would actually need to do a calibration with a

2 bunch of different parameters. And then in the

3 extreme case, if one were attempting to formulate

4 an affirmative recommendation of rates and proffer

5 them, then to take -- the approach that I employed

6 might be used, but it would then require a

7 calibration.

8   Q   So I think you just acknowledged, and I

9 think you acknowledged earlier today as well, you

10 didn't do any real-world analysis to calibrate

11 your model, correct?

12   A   I guess I would push back a little bit

13 on real-world analysis. I did not try to

14 calibrate the model with market data, that's

15 correct.

16   Q   So you didn't use any real-world data to

17 calibrate your model.

18   A   Well, once again, I'm going to push back

19 on this a little bit. The formulation of the

20 bargaining framework was based on my understanding

21 of the record as it's developed. The theoretical

22 part that makes no distribution or assumptions of

23 it in a continuous distribution lays out most of

24 the conclusions of the crowding out and the

25 selection bias effect without any calibrated

1   parameters whatsoever. So one way to view the

2   simulations in the text is a way to distill this

3   down in a way that people can sort of see what's

4   happening as opposed to showing an interval and

5   saying that it's increasing in a particular

6   parameter.

7   Q   Now, as you put it at your deposition,

8   to run your simulations you simply posited some

9   numbers, correct?

10   A   One has to posit some initial numbers.

11   That's true in any -- even if one were to go

12   forward with a calibration exercise, the standard

13   way to do that is to posit some initial numbers

14   and then update it in what is essentially a data

15   fitting enterprise.

16   Q   But you didn't do any of that data

17   fitting enterprise as you just discussed, correct?

18   A   As I testified earlier this morning in

19   my direct examination, it was unnecessary given

20   the ambit of my rebut as an expert, as a rebuttal

21   expert to Professors Katz and Shapiro.

22   Q   In your model you pair a randomly

23   selected buyer and a randomly selected seller,

24   correct? That's how it works?

25   A   Not just one.

6100

1   Q   Each draw is -- in your simulation you

2 pair many, many random selected buyer, but in each

3 instance of the draw there is one random buyer and

4 one random seller pulled, correct?

5   A   So the buyer and seller are drawn from

6 this distribution, and that could be in the

7 general case as well, and in the bivariate normal

8 simulations that are used to illustrate the more

9 general argument, they are drawn from a

10 distribution that has some -- potentially, they

11 have some correlation, but yes, they are plucked

12 out of this distribution as a pair, and they're

13 randomly distributed around.

14   Q   And that buyer and that seller then

15 negotiate over something? I think you used -- in

16 your deposition, at least, you referred to it as a

17 per-play rate.

18   A   Well, the rate -- there are

19 essentially -- I think in my deposition I used the

20 bundles of rights that are being sold. I think,

21 in fact, maybe even in my discussion with you in

22 my deposition this could have multiple features

23 associated with it. A price would eventually

24 emerge and the model expresses them in terms of

25 per-play rates, but, as has happened in this case

1 as well, one can formulate different types of

2 payment. And to compare apples to apples, you

3 have to do it on some basis. So it does this in

4 the sense of per-play rates.

5   Q   Recognizing there's a lot of things you

6 could have done, what you represented in the model

7 is that the buyer and seller would be negotiating

8 over a per-play rate, correct?

9   A   That's one way to express a price, but,

10 remember, if there are -- I mean, another way is

11 the aggregated amount of money that's going to be

12 paid. So, functionally, yes, this is -- this is a

13 sufficient way to describe those simulations, but

14 the bargaining environment is more general than

15 that.

16   Q   Now, the end result of this hypothetical

17 negotiation between this randomly plucked buyer

18 and randomly plucked seller is either that a deal

19 is struck, and that's dictated by the five

20 critical parameters in your simulation, or there's

21 no deal, correct?

22   A   Not quite. Whether a deal is struck is

23 going to be determined by whether the buyer's

24 willingness to pay exceeds the seller's

25 willingness to accept.

1   Q   Isn't that dictated by the five critical

2   parameters?

3   A   It is not dictated. Those parameters in

4   the simulations, again, that illustrate the more

5   general argument, are essentially probabilistic

6   parameters. So there's a probability that is

7   dictated by that distribution that the buyer may

8   value more than the seller, a probability that the

9   buyer doesn't value more than the seller and

10 there's no deal to be had there. So that's the

11 nature of the enterprise.

12   So it is true to say that the parameters

13 in the simulation portion of my analysis helps

14 shape what types of dyads we are likely to draw

15 out of the population. They do not foreordain

16 whether there's a deal to be had or not. That's

17 essentially a deliberately designed-in

18 randomization process.

19   Q   There aren't any other parameters other

20 than these five critical ones that are entering

21 into your model, correct?

22   A   That's incorrect. In fact, the general

23 model at the end does not use --

24   Q   I'm sorry, I'm just referring to your

25 simulations.

1   A   That's not the model, the simulations?

2   Q   The simulations.

3   A   I see. So the simulations are based on

4 a bivariate normal distribution, which is fully

5 defined by five parameters.

6   Q   Now, the outcome of the negotiations

7 between a given buyer-seller pair, or dyad, as

8 predicted in your simulations, is not impacted in

9 any way by prior or subsequent negotiations

10 between another buyer-seller pair, is it?

11   A   Well, these buyer-seller pairs are drawn

12 out independently, and one way to view it is

13 they're drawn out, you know, sort of all at the

14 same time, and they're negotiating with one

15 another. So they may have conjectures about what

16 contracts are being reached elsewhere and that can

17 inform the willingness to pay or willingness to

18 accept of the buyer and seller.

19   Q   So let's take a look at your deposition

20 to see what you said when I asked you that

21 question a few weeks ago. If you could turn to

22 page 160, line 24.

23   A   I'm there.

24   Q   I'm just giving the judges a moment to

25 get there as well.

6104

1   JUDGE STRICKLER: Thank you.

2   Q   Now, at the bottom of 160 at line 24, I

3   asked you the following question, "So a rate

4   negotiated by one dyad will have no effect on the

5   rate that's ultimately negotiated by any other

6   dyad; is that right?" Mr. Choudhury objected,

7   "You mean within the model?" To Mr. Choudhury, I

8   responded, "Within the model." Then you answered,

9   "Yeah. So within the model, the rate that's

10 negotiated is, you know, essentially out of these

11 independent pairings of buyers and sellers and

12 that there is not modeled into this, although I

13 think it probably could be adapted to do this, I

14 guess, a pricing externality associated with the

15 price that we reach somehow affects the valuation

16 of the other people have in that transaction. It

17 would be possible to work that in. It would be

18 somewhat more complicated, but a simulation

19 environment certainly could do that."

20   Is that the testimony that you gave?

21   A   Well, it depends on the understanding of

22 the context. So I --

23   Q   Is that the testimony that you gave at

24 your deposition?

25   A   Well, let me make sure that I'm clear

1   about this. It's not inconsistent with what I

2   just said.

3   Q   I didn't ask you that question. I just

4   asked, is this the testimony that you gave at your

5   deposition?

6   A   I understand, but the context in which

7   we were making -- having this discussion is one

8   way that the model can play out. So let me -- I'm

9   going to try to answer this.

10   MR. EBIN: Your Honors, if I could just

11 get an instruction for the witness to answer the

12 question.

13   CHIEF JUDGE BARNETT: Dr. Talley, it's a

14 yes or no question.

15   A   So that is a correct reading of the

16 transcript at the deposition.

17   Q   Thank you. And your simulations also do

18 not account for the possibility that a rate

19 negotiated between a buyer and seller might be

20 used in a future CRB proceeding as a benchmark,

21 correct?

22   A   Well, we had a discussion about this.

23 My assessment was that if there were a sufficient

24 number of these, that it wasn't clear that that

25 needed to be worked into the model.

6106

1   Q   But it's not something that you've

2   worked in your model, correct?

3   A   Yes, I think there are reasons not to,

4   though.   It would depend on the context.

5   Q   But, again, you didn't do that, correct?

6   A   It's not worked in the model, right.

7   Q   Thank you.

8   Let's turn to a hypothetical.

9   A   Sure.

10   Q   Suppose -- and this will be a variation

11   on some of the demonstratives you walked through

12   with Mr. Blavin earlier this morning. Suppose all

13   of the buyers in my hypothetical have a

14   willingness to pay of up to 15 cents. I'm just

15   going to use the shorthand "15" so we can avoid

16   zeros and decimal points, .0015 dollars, but I'll

17   just say 15 cents for present purposes.

18   A   So let me make sure that I understand

19   the hypothetical. So are you saying that

20   15 cents -- I'm going to use your same, I don't

21   know, multiplication by a hundred, I guess.

22   Q   Fair enough.

23   A   -- that that is the upper bound of

24   buyers' willingness to pay?

25   Q   Yes.

1   A   But there's a distribution of

2 willingness to pay in there? Is that a ceiling, I

3 guess?

4   Q   All of buyers have a willingness to pay

5 at 15 cents.

6   A   So buyers are not heterogeneous.

7   Q   Exactly.

8   A   So buyers are all identical in your

9 setting.

10   Q   In their willingness to pay.

11   A   Okay.

12   JUDGE STRICKLER: I just want to make

13 sure of your hypothetical. Did you say all buyers

14 have a willingness to pay up of to 15 cents --

15   MR. EBIN: Yes.

16   JUDGE STRICKLER: -- or of 15 cents?

17   MR. EBIN: I understood, based on my

18 conversation with Professor Talley at his

19 deposition that, in his view, those were the same

20 thing.

21   THE WITNESS: No, that's not my

22 understanding. That's why I was confused as well.

23 When you say "up to," that sounds like it's a

24 range and there might be some distributions or

25 heterogeneity within that range.

6108

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 1       Q     Let's simplify things.  We'll just say

 2  of 15 cents.

 3       A     Exactly 15 cents, so no buyer

 4  heterogeneity.

 5       Q     And all sellers have a willingness to

 6  pay of 5 cents -- sorry -- willingness to accept

 7  of 5 cents.

 8       A     Of 5 cents.

 9       Q     Yes.

10       A     And there's no heterogeneity.

11       Q     Correct, all buyers and all sellers are

12  the same in this hypothetical.

13       A     At least on this dimension, the

14  willingness to pay and willingness to accept, all

15  buyers are identical and all sellers are

16  identical.  Is that what I understand you --

17       Q     Yes, it sounds like you're with me so

18  far.

19       A     Okay.

20       Q     Now let's further assume that there are

21  differences in the bargaining power of the buyers

22  and sellers such that the negotiated rates we

23  would see range anywhere from 7 and a half cents

24  on the low end to as high as 12 and a half cents

25  on the high end.
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1   A   Correct.

2   Q   All within the range of willingness to

3 pay and or willingness to accept.

4   A   So I'm going to recapitulate this just

5 so that I can follow your hypothetical. So we

6 have these identical buyers at 15 cents willing to

7 pay, identical sellers at 5 cents willing to pay.

8 But when they negotiate with one another, there is

9 heterogeneity of bargaining power --

10   Q   Exactly.

11   A   -- so they split the pie at different

12 points. And some contracts end up as low as 7 and

13 a half, is that what you said?

14   Q   That's correct.

15   A   And as high as?

16   Q   12 and a half.

17   A   12 and a half.

18   And do you have a particular

19 distribution in mind on that --

20   Q   For purposes of the hypothetical, I

21 don't think it makes any difference.

22   A   Okay.

23   Q   If it does, I'm sure you'll let me know.

24   A   I suspect I will.

25   Q   Just to be clear, in this hypothetical,

1   these are the rates that we see in the absence of

2   a statutory license.

3   A   I think I follow you, yes.

4   Q   Good.

5   Now, let's impose a statutory license of

6   14 cents.

7   A   I follow you, yes.

8   Q   With me so far.

9   So according to your model, every single

10 one of the negotiated transactions that would have

11 been entered into in the absence of that statutory

12 rate of between 7 and a half cents on the low end

13 and 12 and a half cents on the high end will all

14 now all be pulled up to that 14-cent statutory

15 rate, correct?

16   A   Well, two things will happen. One is

17 that they will be pulled up to -- it's 14 cents

18 that you posited?

19   Q   14 cents.

20   A   -- that the buyer's willingness to pay

21 exceeds 14 cents and, therefore, it becomes common

22 knowledge that the buyer would be willing to buy

23 at 14 cents. The seller would know this and would

24 say, well, look, I can -- any of those sellers

25 between 7 and a half cents and 12 and a half cents

1   would say I can get a better deal by just not

2   bargaining. So, A, you're correct that those

3   deals would get pulled up to 14 cents, but, B,

4   they would also no longer be consensual deals.

5   Q   So the answer to my question was, yes,

6   they would all get pulled up to 14 cents, correct?

7   A   That is a roundabout way of saying yes.

8   Q   Thank you.

9   So I take it, then, that you would agree

10 that whether and the extent to which a statutory

11 license either pulls up or pulls down negotiated

12 rates to the statutory level in your model is

13 dependent on the level at which that statutory

14 rate is set, correct?

15   A   I, unfortunately, would not agree, and

16 that's why I asked you the question of negotiated

17 rates. So you've just given me an example in

18 which there were a bevy of negotiated rates. They

19 all disappeared and turned into non-negotiated

20 rates. So I think the answer --

21   Q   Let me ask my question again because I

22 don't think you've answered it. I'll try it

23 again.

24   A   I think I answered the question that you

25 asked.

6112

1   Q   Let me try again, see if we still have

2 some misunderstanding.

3   So you would agree that whether and the

4 extent to which the statutory license either pulls

5 up or pulls down otherwise negotiated deals to the

6 statutory level is dependent on the level at which

7 that statutory rate is set?

8   A   Okay, so you have now dropped the word

9 "negotiated" out of the question, I think, so,

10 yes, in this particular example, it's an example

11 where the rates that emerge are all non-negotiated

12 and they would be pulled up from negotiated rates

13 to non-negotiated rates. This is, essentially, I

14 think when Mr. Blavin was taking me through my

15 direct, there's a crowding down and a crowding up,

16 and you've given me a hypothetical in which no

17 one's above the statutory rate.

18   Q   Right, there's just a crowding up, if

19 you will, rather than crowding down in this

20 hypothetical.

21   A   Right, and if you've located this

22 hypothetical by assuming the perfect knowledge and

23 no heterogeneity and valuation of buyers.

24   Q   So let's leave my hypothetical and turn

25 back to the model.

1   CHIEF JUDGE BARNETT: Before we leave

2   there, so you have negotiated deals, and the

3   seller's willingness to accept is at 5, they

4   negotiated at no less than 7 and a half. Why

5   would they not jump at a 14-cent rate?

6   THE WITNESS: Well, the sellers in this

7   instance are going to jump at a 14-cent rate. The

8   strategic issue is this. It's the buyer's option

9   whether to pay that 14-cent rate or negotiate. So

10   the seller initially is thinking, wow, I would

11   love to get a 14-cent rate, but it's not up to me.

12   The buyer's got to opt into this 14-cent rate.

13   And one of the phenomenon in the structural model,

14   Mr. Ebin has given an example where there's

15   essentially no buyer or seller heterogeneity, in

16   which the seller might think, okay, I can get this

17   9-cent price, but I know that I'm bargaining

18   against the buyer, who is going to be willing to

19   pay the statutory rate. So maybe I'll just refuse

20   to bargain and let this deal go off at a

21   non-negotiated price.

22   That's essentially the dynamic that I

23   worked through with Mr. Blavin this morning as

24   well as another example, I think, of what Mr. Ebin

25   is asking me now.

6114

1   CHIEF JUDGE BARNETT: Okay, thanks.

2   THE WITNESS: Sure.

3   BY MR. EBIN:

4   Q   In the answer you just gave, you seem to

5   be suggesting that it's entirely up to the buyer

6   as to whether the deal would be struck -- whether

7   there would be a negotiation or whether we'll just

8   end up at the statutory rate. In fact, it's the

9   case, is it not, that the seller can simply say,

10 I'm not going to talk to you, I'm just going to --

11 if you're going to use my stuff, it's going to be

12 at the statutory rate, correct?

13   A   That's possible, yes.

14   Q   So now leaving the hypothetical, unless

15 Your Honors have any more questions.

16   Now, according to your model, whenever

17 there's a deal that is actually entered into

18 between a statutory webcaster and a record label

19 in the shadow of the statutory license, that exact

20 same transaction would take place in the absence

21 of the statutory license, correct?

22   A   So I think -- I'm going to try to

23 respond to your question by --

24   Q   Please.

25   A   So if there were a deal that is still a

6115

1   negotiated deal --

2   Q   Negotiated deal.

3   A   -- that takes place in the shadow of the

4   statutory license, then that deal would be a deal

5   that you might still see if those same pair was

6   plucked out under a non- -- in a world without the

7   statutory license.

8   Q   So for that transaction, according to

9   your model, the statutory rate has no impact on

10   the negotiated deal, correct?

11   A   It has -- it ends up being above the

12   maximum willingness to pay of the buyer. So

13   similar -- think about a world -- one way to think

14   about this, Mr. Ebin, is suppose the statutory

15   rate --

16   Q   I'm sorry, Professor Talley, this is a

17   yes or no question.

18   A   Now I can't remember what --

19   Q   For that transaction, according to your

20   model, the statutory rate has no impact on the

21   negotiated deal, correct?

22   A   If it's above the highest conceivable

23   valuation number, it would not have, right.

24   Q   So applying your model, then, to the

25   Pandora-Merlin deal, your model, therefore, would

1   imply that Pandora and Merlin would have reached

2   exactly the same deal terms in the absence of the

3   statutory license as they did in its presence,

4   correct?

5   A   It's possible. I know Pandora has put

6   forward the view that this is a -- that the deal

7   terms here are less than the pureplay rate. One

8   other possibility, since there are other

9   accoutrements of the Pandora-Merlin deal, is that

10   it's functionally the equivalent of the per-play

11   rate, but, you know, due to other aspects of the

12   pricing behavior, the per-play part got washed

13   down while other parts, like guarantees and

14   steering, ended up making up the difference.

15   So it's possible that the Merlin deal is

16   right -- is functionally right at the pureplay

17   rate, but it is also possible that it is one of

18   these that's below.

19   Q   Whether or not the Merlin deal is

20   functionally, as you put it, at the per-play rate,

21   that's not something you investigated or discussed

22   in your written rebuttal testimony, it is?

23   A   It could go either way.

24   Q   You did no quantification of that, did

25   you?

6117

1   A   I did not.

2   Q   One last topic. At the time of your

3 deposition, it was your view that record labels

4 would likely want to license their works to

5 Pandora because, with its large listener base,

6 Pandora can help that label reach lots of

7 different potential listeners, correct?

8   A   I assume you're reading something from a

9 transcript, so I will --

10   Q   Does that sound right to you?

11   A   It might, yes. I possibly said that,

12 yes.

13   Q   We can take a look if you like.

14   A   I'll accept your stipulation.

15   Q   It was also your view at the time of

16 your deposition that this enhanced exposure

17 provided by Pandora and other noninteractive

18 webcasters will likely lead to increased sales of

19 downloads and CDs, correct?

20   A   It could, yes.

21   MR. EBIN: Thank you. No further

22 questions.

23   MR. JOSEPH: No questions, Your Honor.

24   MR. MILLER: No questions, Your Honor.

25   MR. TOOF: No questions, Your Honor.

1   MR. BLAVIN: Brief redirect, Your Honor.

2   CHIEF JUDGE BARNETT: Yes.

3 REDIRECT EXAMINATION BY COUNSEL FOR SOUNDEXCHANGE

4 BY MR. BLAVIN:

5   Q   Professor Talley, if we can turn back to

6 your deposition transcript, page 161 -- 160,

7 line 24, through 161, line 14, you said that you

8 were just going to -- when you were having the

9 back-and-forth with Mr. Ebin, you noted that you

10 had further context to provide with respect to

11 that answer. Would you mind providing that?

12   A   So you're -- excuse me, what pages

13 again?

14   Q   Sorry, page 160.

15   A   Oh, yes.

16   Q   I believe the question was -- begins at

17 line 24.

18   A   Yes. Right. Oh, yes, yes. Thanks.

19   So here's the deal. So I believe

20 Mr. Ebin had asked whether the terms of contracts

21 reached by parties would have any effect on other

22 contracts reached by parties. And what I was

23 going to add, but didn't have the opportunity to,

24 is that one way that this model can be viewed,

25 these parties are essentially -- they're

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1 negotiating one on one, but they may have an

2 understanding or a conjecture, an equilibrium

3 conjecture about the contracts that are being

4 entered into economy-wide. That conjecture would,

5 in fact, have an effect on their willingness to

6 pay or willingness to accept.

7   So the nature of contractual

8 attractiveness certainly could affect the contract

9 status that these parties work out simply because

10 it gets baked into their willingness to pay more

11 than is acceptable.

12   Q   Thank you for that.

13   Now, with respect to the model that we

14 went over before, in which there was a range of

15 rates and then the imposition of the statutory

16 rate, now, for that initial range of rates, were

17 those rates negotiated in the backdrop of an

18 existing statutory rate when they were charted

19 through your simulations?

20   A   No.

21   Q   And the Pandora-Merlin agreement, to

22 your understanding, was negotiated in the backdrop

23 of the statutory and pureplay rates; is that

24 correct?

25   A   My understanding is that the Pandora and

1   Merlin deal was, in fact, negotiated in the

2   backdrop of the pureplay rates.

3   MR. BLAVIN: Thank you. No further

4   questions.

5   MR. EBIN: Nothing further.

6   CHIEF JUDGE BARNETT: Thank you,

7   Dr. Talley.

8   Any other questions from the judges?

9   Thank you, Dr. Talley.

10   THE WITNESS: Thank you.

11   (Witness excused.)

12   CHIEF JUDGE BARNETT: Mr. Pomerantz, I

13 think, were those two witnesses taken out of

14 order, then?

15   MR. POMERANTZ: Correct. Now we're

16 going to go back and have three of theirs, I

17 think. Then that's, for now, the end of their

18 case.

19   MR. RICH: Your Honor, our next witness

20 will be, for Pandora, Simon Fleming-Wood, and

21 Mr. Larson will be conducting the examination.

22   CHIEF JUDGE BARNETT: Thank you.

23   - - -

24   SIMON FLEMING-WOOD,

25 having been duly sworn, testified as follows:

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1   MR. LARSON: May I proceed?

2   CHIEF JUDGE BARNETT: You may.

3   DIRECT EXAMINATION BY COUNSEL FOR PANDORA

4 BY MR. LARSON:

5   Q   Could you state your full name for the

6 record, please.

7   A   My name is Simon Fleming-Wood.

8   Q   Could you spell the last name for us,

9 please.

10   A   F-L-E-M-I-N-G hyphen W-O-O-D.

11   Q   Thank you.

12   Mr. Fleming-Wood, could you please

13 briefly describe your background, educational and

14 work background prior to joining Pandora.

15   A   Certainly. I graduated from Stanford

16 University in 1991 with a bachelor's in political

17 science. Since then, I've held a series of

18 ever-more-senior marketing roles. Before Pandora,

19 I was the vice president of marketing of a company

20 called Pure Digital Technologies, which made the

21 Flip Video Camera, which was sold to Cisco. I

22 spent about two years at Cisco running marketing

23 for their consumer group.

24   Q   When did you join Pandora?

25   A   In October of 2011.

1   Q   What is your job title at Pandora?

2   A   Chief marketing officer.

3   Q   That's the position you've had since

4   you --

5   A   My feet don't touch the ground. Someone

6   was taller than me, apparently.

7   Q   So you've been the chief marketing

8   officer since you joined in 2011?

9   A   Yes.

10   Q   What are your job responsibilities as

11   Pandora's chief marketing officer?

12   A   I run multiple teams at Pandora. I have

13   responsibility for brand and analytic marketing.

14   I have responsibility for business development as

15   well as the communications in the PR function, as

16   well as the Pandora One subscription business.

17   Q   Does your job involve analyses of other

18   music services that operate in the market along

19   with Pandora?

20   A   It does.

21   Q   What sort of analyses of other market

22   participants does your team conduct?

23   A   We take it upon ourselves to understand

24   the landscape of music services available to

25   consumers. We feel like we're in a very, sort of,

1   loud space. There's always a lot of news.

2   Pandora is often mentioned in stories about other

3   services. So we feel like it's incumbent upon us

4   to understand the perceptions about these services

5   in the marketplace.

6   Q   Now, your testimony in paragraph 3

7   describes marketing analytics as part -- as

8   falling under your purview. Could you just

9   explain what that means with respect to your

10   competition.

11   A   Yes. So we understand -- we seek to

12   understand the users of the other music services

13   in the landscape. We seek to understand how many

14   users they have, what their performance is in the

15   app stores, so that we can keep track of how

16   they're doing.

17   Q   Is some of that work in the nature of

18   surveys and quantitative research and that sort of

19   thing?

20   A   Yes, qualitative and quantitative

21   research.

22   Q   Did you prepare written direct testimony

23   in connection with this proceeding?

24   A   I did.

25   Q   So there's a binder in front of you. If

1 you could take a look at what's been marked as the

2 tab Pan Ex 5002. Do you see that?

3   A   I do.

4   Q   Do you recognize that as your written

5 direct testimony in this case?

6   A   Yes.

7   Q   Your signature is on the last page of

8 this document?

9   A   Yes.

10   MR. LARSON: Your Honor, I would offer

11 Pandora 5002 into evidence.

12   MR. KLAUS: No objection.

13   CHIEF JUDGE BARNETT: 5002 is admitted.

14   (Pandora Exhibit 5002 was admitted into

15 evidence.)

16 BY MR. LARSON:

17   Q   Then I would also move -- if you could

18 look at tab 5003, 4, and 6. Actually, I'll note

19 that 3 and 6 are videos that are on a disc that's

20 tucked inside the first inside sleeve. Are

21 Exhibits 5003, 5004, and 5006 -- were those

22 appended exhibits to your written testimony?

23   A   Yes, they were.

24   MR. LARSON: I would offer those three

25 exhibits into evidence.

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1   MR. KLAUS: No objection on 5003 and

2 5006, Your Honor. 5004 is a portion of a document

3 where there is an exhibit number for the full

4 document. We would object on completeness grounds

5 and ask that the entirety of the exhibit be -- the

6 entirety of the document be admitted.

7   MR. LARSON: That's acceptable to

8 Pandora.

9   CHIEF JUDGE BARNETT: Can we

10 cross-reference what the original exhibit number

11 was?

12   MR. KLAUS: Yes, the original exhibit

13 number that --

14   CHIEF JUDGE BARNETT: Or the other.

15   MR. KLAUS: The other -- the other that

16 corresponds to 5004 is SoundExchange Exhibit 1679.

17   CHIEF JUDGE BARNETT: And that has been

18 admitted?

19   MR. KLAUS: It has not been admitted.

20 We were going to seek to admit it, but if

21 Mr. Larson is happy to do so, then I think we can

22 have agreement on that.

23   MR. LARSON: Yes.

24   CHIEF JUDGE BARNETT: Thank you.

25 Exhibit 1679 is admitted.

1   (SoundExchange Exhibit 1679 was

2   admitted into evidence.)

3   CHIEF JUDGE BARNETT: And for purposes

4   of referring to the document during the

5   examination of Mr. Fleming-Wood, Mr. Klaus,

6   there's no objection to us looking at these few

7   pages?

8   MR. KLAUS: No.

9   CHIEF JUDGE BARNETT: You're welcome to

10   use the entire document for cross-examination.

11   MR. KLAUS: Sure.

12   BY MR. LARSON:

13   Q   So Mr. Fleming-Wood, let's turn to the

14   first substantive topic in your testimony, which

15   is identified as the Pandora listening experience.

16   CHIEF JUDGE BARNETT: Before that, let

17   me make sure that 5003 and 5006 are admitted and

18   5004 is admitted in the body of 1679.

19   (Pandora Exhibits 5003, 5004, and 5006

20   were admitted into evidence.)

21   BY MR. LARSON:

22   Q   So is Exhibit 5003, Mr. Fleming-Wood, a

23   video showing the basic Pandora functionality?

24   A   Yes, it is.

25   Q   Although we are four and a half weeks

6127

1 into our trial here, I think we'll spend a few

2 minutes taking a look at that video now, if we

3 could.

4   (Video played as follows:)

5   "How to listen to Pandora. Pandora

6 Internet Radio can be accessed from all kinds of

7 personal computers, mobile phones and tablets, and

8 even through one's car."

9   "Pandora, please say a command."

10   "Play station Michael Zapruder Radio."

11   "Tuning to station Michael Zapruder

12 Radio."

13   (Music playing.)

14   "Simple tasks, all voice-activated."

15   "Listeners can listen to Pandora on

16 their computers by simply opening an Internet

17 browser and typing www.Pandora.com. Those wishing

18 to listen to Pandora on their mobile phone can

19 download and install the app free from the iTunes

20 Store or the Android marketplace. Each first-time

21 user is prompted to create a Pandora account by

22 providing their e-mail, birth year, ZIP Code,

23 gender, and creating a personal password.

24   "Listeners are then prompted to seed a

25 station by typing the name of an artist, song, or

1 musical genre they wish to hear. When ready,

2 Pandora's propriety music recommendation engine,

3 the Music Genome Project, will automatically begin

4 streaming a personalized radio station consisting

5 of songs with relevant musical similarities to the

6 seed.

7   "Listeners can click buttons

8 representing a thumbs up or a thumbs down to

9 signify whether they like or dislike each song

10 chosen for them, and their Pandora station will

11 learn and factor these ratings when making future

12 song selections. Listeners do not have to thumbs

13 up or thumbs down songs. Pandora's Music Genome

14 Project will continue to stream musically related

15 songs without any input from the listener.

16   "When available, Pandora displays

17 biographical information about a performer as well

18 as a list of similar artists that listeners may

19 enjoy and the song's lyrics. Banner advertising

20 is displayed and audio advertising is interspersed

21 between songs within the music stream. Because

22 Pandora's musicologists review songs that go into

23 the Music Genome, Pandora is able to use

24 musicological similarities to play new music or

25 songs by lesser known artists that listeners are

1 likely to enjoy.

2 "Take, for example, the little-known

3 band Orion the Hunter, which featured musicians

4 formerly associated with the very popular band

5 Boston and shared musical similarities with

6 another successful band, Journey, especially the

7 high-flying vocals of Orion the Hunter singer Fran

8 Cosmo" --

9 (Music playing.)

10 -- "and Journey singer Steve Perry."

11 (Music playing.)

12 "Thanks to the Music Genome Project's

13 ability to identify these similarities, thousands

14 of Pandora listeners, who may have never heard of

15 Orion the Hunter, have been organically introduced

16 to songs from Orion the Hunter that they may

17 enjoy.

18 "In addition to giving songs a thumbs up

19 or down, listeners can personalize their existing

20 stations by clicking the Add Variety button and

21 then typing the names of other artists or songs

22 they like.

23 "Because music is often a shared

24 experience, Pandora listeners can share their

25 stations with others. For example, listeners can

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1   click the Options button and make their stations

2   visible to other listeners, find other listeners

3   who like the same music, or associate their

4   Pandora account with their Facebook account and

5   share things such as what station they are

6   listening to or what song they thumbed up.

7   "Listeners may also pause songs they're

8   listening to and skip ahead to the next song but

9   may not skip more than six songs per station per

10 hour or 12 songs in a 24-hour period.

11   "Listeners may also click on the New

12 Station button to create additional personalized

13 radio stations based on other songs, artists, or

14 musical genres. With these simple tools,

15 consumers can put Pandora's Music Genome Project

16 to work for them and create personalized radio

17 stations."

18   (End of playing of video.)

19 BY MR. LARSON:

20   Q   So Mr. Fleming-Wood, is the video we

21 just watched consistent with your understanding of

22 how Pandora works?

23   A   It is, with one exception.

24   Q   And what was the exception?

25   A   That the daily skip limit is 24 and not

1   12.

2   Q   Thank you.

3   Can the Pandora user pick the song he or

4   she will hear on Pandora?

5   A   No.

6   Q   Does the Pandora user know what song is

7   going to play next?

8   A   No, not until it starts.

9   Q   So once a station is seeded and playing,

10   how are subsequent songs, at a basic level, chosen

11   by Pandora?

12   A   So, as the video portrayed, the Music

13   Genome Project is our, sort of, underlying

14   technology for recommending songs.

15   Q   Again, we've heard a good bit about the

16   Genome Project during the course of the trial, but

17   could you give us a couple sentences explaining

18   what that is, on a basic level.

19   A   Sure.

20   So the Music Genome Project is this

21   labor of love that started actually six years

22   before Pandora ever launched of collecting, sort

23   of, musical DNA level millions of -- well, at the

24   time, thousands of songs, now over a million

25   songs, and dissecting it into as many of 450

1   different attributes.

2   So in the case of the vocal performance,

3   there are as many as 20 different attributes

4   describing that vocal performance. It's done by

5   professional musicologists and musicians who are

6   all highly trained and expert. So that database

7   then becomes the sort of backbone for making -- I

8   think of it almost like a constellation of endless

9   stars, but in this case it's songs and musical

10   attributes, for making connections in a

11   multidimensional universe between songs.

12   Q   Your testimony at paragraph 17 also

13   mentions playlist algorithms that Pandora uses

14   along with the Genome Project. Could you just

15   explain what you mean by that, those playlist

16   algorithms.

17   A   So in addition to that, sort of,

18   foundation of musicological DNA-level data on

19   songs, Pandora has built over the years dozens of

20   algorithms using both that data as well as thumb

21   data and other feedback from listeners to

22   determine the best song to play for any individual

23   listener on any individual station. At any given

24   moment on Pandora, there are as many as 50

25   different algorithms running, so essentially

1 competing to choose the next song that plays for

2 Pandora.

3   And so the personalization itself is

4 actually under the hood personalized because the

5 winning algorithms for me might be different than

6 the winning algorithms for you. In fact, they

7 might be different on different stations. So the

8 personalization of Pandora is sort of the

9 multilayered, but, essentially, those 50

10 algorithms are all nominating the next song to

11 play for that listener based on multiple

12 approaches.

13   Q   So does that mean that the algorithms

14 identify a single song that should be played next

15 or a group of possible songs to play next?

16   A   So each of the algorithms is nominating

17 its own song, right? And then a master algorithm

18 sort of sits on top of it and chooses who gets to

19 win, but that's the general framework.

20   Q   The video showed thumbs up and thumbs

21 down. What ways, other than thumbing up and

22 thumbing down, can a user influence what songs

23 they hear on Pandora?

24   A   Really only by skipping, but thumbs up

25 and thumbs down are the major ways that Pandora

1 collects feedback.

2   Q   Does a Pandora user have to use the

3 thumbs?

4   A   No, they don't.

5   Q   Do you have data on to the extent to

6 which they do or don't?

7   A   Yes. Just over 50 percent of Pandora

8 monthly users would thumb. So almost 50 percent

9 would not.

10   Q   Do Pandora users have the ability to

11 rewind or fast-forward or replay songs?

12   A   No.

13   Q   More generally, how does the Pandora

14 listening experience compare to what a user

15 experiences with an on-demand service like Spotify

16 or Rhapsody?

17   A   Sure. Well, Pandora is a radio

18 experience.

19   CHIEF JUDGE BARNETT: Would you pull the

20 mic just a little closer.

21   THE WITNESS: Yes. I'm sorry.

22   CHIEF JUDGE BARNETT: Thank you.

23   A   So Pandora is a radio experience where

24 the user doesn't know what song is going to play

25 for them next. It's programmed by the service.

1   They have no control over what plays next, and

2   they don't know it until it begins playing for

3   them.

4   On-demand services, by their nature, are

5   controlled by the user. The user can select

6   either the playlist, they can build the playlist,

7   they can choose the exact song in most cases. And

8   that's something that somebody goes into with the

9   intention of wanting to hear something very

10   specific. Pandora is something that we refer to

11   as lean-back listening, where people go in wanting

12   a radio-like experience where they want music

13   played for them.

14   Q   Have you seen the rebuttal testimony of

15   Mr. Kooker from Sony?

16   A   I have.

17   Q   You understand that he claims that

18   Pandora stations seeded with a particular artist

19   always play that artist first?

20   A   I have seen that.

21   Q   What's your reaction to Mr. Kooker's

22   testimony on that point?

23   A   I don't think it's overly valid. It's

24   very simplistic, and we could have told him, could

25   have saved him some time, I think, by explaining

1 that any new listener on Pandora starting a new

2 station, the way that the video even showed it, is

3 that the first time you play an artist in a new

4 station, it will play a song that represents

5 musicologically the work from that artist and from

6 then it will build the playlist. That's just the

7 way that service is built.

8   Q   You mentioned the first time. Does that

9 experience change when users return to a station

10 that they've previously seeded or created?

11   A   Yes, it can. It can. So I often, on my

12 stations, don't hear -- in fact, I would say

13 probably the majority of time do not hear, because

14 I'm a longtime Pandora listener, the artist on the

15 station, unless I haven't listened to it for a

16 long time, then Pandora will try and play that

17 seed artist, but if it's a station that you

18 listened to yesterday, Pandora is unlikely to play

19 that artist first.

20   Q   When Pandora users seed an artist

21 station, do they know what songs it will play?

22   A   No.

23   Q   Are there limits on how many times the

24 selected artist can play?

25   A   Yes. So we adhere to the performance

1   complement for sound recordings, and that's for

2   songs by a seed artist over a period of three

3   hours.

4   Q   Has the Pandora interface changed in any

5   material way since the product was launched in

6   2005?

7   A   No, the major sort of thrust of Pandora,

8   the engineering and product team, since the

9   product launch, was expanding it to other

10   platforms. So whereas it started on the desktop,

11   it is today on over 1,000 consumer electronic

12   devices. It's on every significant mobile

13   smartphone platform. And, obviously, it's in a

14   lot of cars as well, over 160 cars.

15   Q   But has the -- recognizing, I think you

16   described that in your testimony, that it's

17   available in new places, has the basic

18   functionality of the service changed as it's

19   expanded to those new locations?

20   A   No. We've added some ancillary things

21   like bios and, in some cases, lyrics. But, no,

22   the major functionality of Pandora has not changed

23   dramatically at all.

24   Q   Let's shift gears slightly and talk

25   about the competitive landscape in which you

1 operate.

2   Who does Pandora view as its chief

3 competition for listeners?

4   A   Given that we're a radio service, we

5 believe we compete most directly with FM radio,

6 which is where the bulk of music listening occurs.

7   Q   Why do you say that, why broadcast

8 radio?

9   A   Well, we see this as lean-back style of

10 radio listening, which represents about 80 percent

11 of all music consumption in the U.S. today, and

12 compare that with what we refer to as lean-in

13 listening, which, when a user approaches their

14 music experience knowing what they want to hear,

15 in the old days, that was your record collection,

16 it was your cassettes. That's obviously changing

17 before our very eyes. But the notion that users

18 have a distinct use case in mind when they go to

19 listen to music is such that we believe we very

20 firmly compete against other radio-like services.

21 And it so happens that that is the bulk of music

22 listening, is the majority of about 80 percent of

23 listening.

24   Q   Does Pandora's expansion into cars

25 impact that view?

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1   A   Well, FM radio today is still, by far,

2 the largest source of music listening in the

3 country, and roughly half of that listening takes

4 place in automobiles. So Pandora's now seven-year

5 march to be available in cars is completely

6 designed to compete for those listener hours

7 because it's such an important part of our growth

8 strategy, frankly.

9   Q   Is the expansion into the auto a company

10 priority for Pandora?

11   A   It's been a company priority for almost

12 a decade.

13   Q   Do you consider on-demand services to be

14 competitors with Pandora?

15   A   From a primary competition for listener

16 hours and advertising dollars, no.

17   Q   Why not?

18   A   Like I was explaining, we see a market

19 that has, sort of, two distinct use cases for

20 people when they want to listen to music. One is

21 a lean-back radio experience where they want music

22 to be played at them, and another is a

23 lean-forward I know what I want to listen to and I

24 want to choose it and control that. Pandora

25 competes in the former bucket. We actually see

1 the second bucket as highly complementary to

2 Pandora, and we're aware of many, many users who

3 use both services on a daily basis.

4   Q   Can you say a bit more about what you

5 mean when you identified Pandora and on-demand

6 services as being complements.

7   A   Yes, I think there's a -- you know, if

8 you were to segment the population, there are a

9 lot of people who listen just to radio-style kinds

10 of things. But there are a lot of people who

11 listen to radio and want to control their

12 music-listening experience at some point. There

13 are also some that always want to control their

14 listening experience.

15   So the group that wants both of those

16 things looks for services that can satisfy both of

17 those needs. So we look at dual usage of

18 platforms or services like Pandora and services

19 like Spotify, and we see a high correlation.

20   Q   What information, if any, do you have to

21 support the view that you just described that

22 on-demand services and Pandora complements?

23   A   Well, I think the first would be

24 research studies, quantitative research studies

25 that we do that show the overlap of our listeners

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1 with on-demand listeners. That would be one. I

2 think also the very fact that Pandora and Spotify

3 have managed to grow side-by-side over the last

4 few years and each grow significantly is also

5 evidence that they're not competing directly with

6 one another. There's room for both services.

7   JUDGE STRICKLER: Excuse me. I have a

8 question for you. Good afternoon.

9   THE WITNESS: Hi.

10   JUDGE STRICKLER: To the extent that the

11 interactive services are now developing things

12 that are more noninteractive in nature, even

13 though they may not be DMCA compliant, does that

14 now put you more in competition with those

15 services because they could be sort of, if you

16 will, one-stop shopping? You could have your

17 lean-forward and lean-back within one service,

18 whereas, in the absence of that, you would need to

19 have the complement as you describe them, Pandora,

20 say, and Spotify?

21   THE WITNESS: In my opinion, no. I

22 think that the initial intent about what someone

23 is looking for in their music-listening experience

24 at that moment determines whether they go to

25 YouTube or Spotify or Pandora.

1   And on top of that, I would point out

2   that the kinds of features that you're mentioning

3   come with a whole set of controls. For example,

4   the playlists that we're talking about, the user

5   has the ability to create those playlists, much

6   like they did with their iTunes library of songs

7   they owned.

8   So they are in control of that

9   experience one way or another, and they obviously

10   know what song is going to play. They know the

11   list of songs that are going to play in most cases

12   because one's listening is still on either the

13   tablet or the desktop. They actually can control

14   it in a completely on-demand fashion, still, in

15   terms of skipping, rewinding features that Pandora

16   doesn't have. So I think I would point out that

17   the control that that allows a user, it

18   capitalizes on a different mind-set.

19   JUDGE STRICKLER: Do any of the

20   interactive services have a radio function whereby

21   the music is played for them, played for listeners

22   at random?

23   THE WITNESS: Yes, I think most of them

24   have a, what they would call the radio function.

25   I don't think it's the primary thrust of any of

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1   them, and I don't think it's a significant size,

2   you know, significant amount of listening on any

3   of the services.

4   JUDGE STRICKLER: But if I was someone

5   who wanted to be in that group that you described,

6   sometimes I want to control the music I hear,

7   sometimes I want to lean back and have music

8   played that I might like, there are services that

9   combine both of those function in one.

10   THE WITNESS: There have been those

11 services ever since Pandora existed and the fact

12 of the matter is that nobody has ever used those

13 services that way.

14   JUDGE STRICKLER: Thank you.

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1 BY MR. LARSON:

2   Q   That actually leads, I think, to our

3 next and last piece of testimony. Did you prepare

4 a written rebuttal testimony in this proceeding?

5   A   I did.

6   Q   I've placed before you what's identified

7 as Pandora Exhibit 5364. Do you recognize that as

8 your written rebuttal testimony in this

9 proceeding?

10   A   Yes, I do.

11   Q   Is that proceeding generally just to

12 summarize some description that you did of various

13 radio-like offerings or allegedly radio-like

14 offerings of certain interactive services?

15   A   It is, yes.

16   MR. LARSON: We would offer Exhibit 5364

17 into evidence.

18   MR. KLAUS: No objection.

19   CHIEF JUDGE BARNETT: 5364 is admitted.

20   (Pandora Exhibit 5364 was admitted into

21 evidence.)

22 BY MR. LARSON:

23   Q   Mr. Fleming-Wood, is there anything in

24 addition to what's in the written testimony that

25 you want to add at this point about those

1 services?

2   A   I think only -- I mean, it was to the

3 question the judge just asked me about services

4 that are positioning themselves a little more as

5 lean-back features but that still give the user a

6 significant amount of control that, in my

7 estimation, would be attractive to a different

8 type of listener than would like Pandora.

9   MR. LARSON: Thank you. I have no more

10 questions.

11   CHIEF JUDGE BARNETT: Thank you,

12 Mr. Larson.

13   Mr. Klaus, you're doing the honors?

14   MR. KLAUS: I am, Your Honor. I

15 apologize while I get set up here.

16   CROSS-EXAMINATION BY COUNSEL FOR SOUNDEXCHANGE

17 BY MR. KLAUS:

18   Q   Mr. Fleming-Wood, good afternoon.

19   A   Good afternoon.

20   Q   My name is Kelly Klaus. I represent

21 SoundExchange. It's nice to meet you. We have

22 not met before, obviously.

23   A   Nice to meet you.

24   Q   Just to follow up on the questions about

25 radio, so your comments about the level of control

6146

1 got me to open my Spotify Radio, for example. And

2 you're familiar with Spotify's radio product,

3 right?

4   A   Generally, yes.

5   Q   And I just happened to pick The Rolling

6 Stones, your radio station, the whole thing got me

7 nostalgic for them. And I notice it brought up --

8 the first song was "Can't You Hear Me Knocking"

9 from "Sticky Fingers." It's gone because I

10 fast-forwarded through it, but I can't get back to

11 that, can I, on the Spotify Radio?

12   MR. LARSON: Objection. Lack of

13 foundation.

14   CHIEF JUDGE BARNETT: Overruled. You

15 can answer if you know.

16   A   Yes, I don't know the answer to that

17 specifically. I would not be surprised if you

18 couldn't. It's within their radio product

19 specifically.

20   Q   And I can flip up, and I can see, boy,

21 everybody knows that, that's "Born in the US" --

22 that's the album "Born in the USA" by The Boss,

23 right?

24   JUDGE STRICKLER: It looks like your

25 finger.

1   MR. KLAUS: Well, here, be careful

2 because it will go away.

3 BY MR. KLAUS:

4   Q   You're from New Jersey. You should know

5 that's Bruce Springsteen that's going to come on

6 next. You don't know what song it's going to be,

7 do you?

8   MR. LARSON: Same objection.

9   A   I don't know. I haven't used that

10 product enough that it's fresh in my memory.

11   Q   And there's not -- on the radio

12 function -- again, this is the radio and I could

13 have picked a whole bunch of other artists, but

14 this is based on The Rolling Stones. There's not

15 a playlist here, is there?

16   A   No, I'm surprised you could even see the

17 album that's next, actually.

18   Q   I can see the album, but I can't see the

19 song, right?

20   A   That's what you're telling me. I don't

21 know that.

22   Q   You have no reason to doubt that you

23 can't see what the song is?

24   A   I don't, no.

25   Q   And you also say in your written direct

1 testimony, you make the comment that, in

2 paragraph 9, that Pandora -- you say, "Pandora

3 features a unique feedback system whereby

4 listeners can further indicate their music

5 preferences by pressing the thumbs up or thumbs

6 down icon while a song is playing."

7   Do you recall that testimony in

8 paragraph 9 of your written direct testimony?

9   A   I see it, yes.

10   Q   That's actually not unique to Pandora,

11 is it, the thumbs up, the thumbs down?

12   A   Well, the thumbs themselves are not

13 unique, but what happens with the thumbs is

14 certainly very unique.

15   Q   And as we can see here -- I can bring it

16 over to you, but Spotify has got thumbs on its

17 radio service, right?

18   A   It appears to.

19   Q   IHeartRadio, they've got thumbs on their

20 service, right?

21   A   Correct.

22   Q   Just in terms of the features and things

23 that your competitors offer to their consumers,

24 the services they offer, the features, that's

25 something that you track through your department,

6149

1 right?

2   A   Yes.

3   Q   And we would find that, for example --

4 in the big binder, if you could turn to tab 18.

5   CHIEF JUDGE BARNETT: This is a

6 restricted document, Mr. Klaus?

7   MR. KLAUS: It's a restricted document,

8 but I'm not going to go into the details of it.

9   CHIEF JUDGE BARNETT: Thank you.

10 BY MR. KLAUS:

11   Q   So Mr. Fleming-Wood, tab 18, this is an

12 example -- this is SoundExchange Exhibit 2244 --

13 of one of your Competitive Intelligence Reports,

14 right?

15   A   I would point out this was not created

16 by my team. It was created by our product team.

17   Q   But it's something that your team is

18 responsible for circulating to the executive

19 staff, right?

20   A   Not this particular report, no.

21   Q   Is it a document that you have received

22 in the course of your work as a member of the

23 executive staff?

24   A   Yes.

25   MR. KLAUS: We move to admit

6150

1   Exhibit 2244, Your Honor.

2   MR. LARSON: No objection. I think it

3   may have been entered already.

4   CHIEF JUDGE BARNETT: It looks familiar

5   to me.

6   MR. KLAUS: This is a different one.

7   This is April of 2014.

8   MR. LARSON: Then I object to lack of

9   foundation. He said only that he received it.

10   CHIEF JUDGE BARNETT: I didn't hear what

11   you said, Mr. Larson.

12   MR. LARSON: I objected to the lack of

13   foundation. He indicated that it was something

14   that he received but not that his team created.

15   CHIEF JUDGE BARNETT: Overruled.

16   2014 is admitted -- excuse me, 2244 is

17   admitted.

18   (SoundExchange Exhibit 2244 was

19   admitted into evidence.)

20   BY MR. KLAUS:

21   Q   If you could just flip ahead a couple of

22   tabs in the binder.

23   JUDGE FEDER: Excuse me one moment. I

24   just noticed that on the live stream here it's

25   coming up as 2224. It is, in fact, 2244, for the

1   record.

2   MR. KLAUS: Thank you, Your Honor.

3   BY MR. KLAUS:

4   Q   Mr. Fleming-Wood, if you could flip back

5   a couple of tabs to tab 16.   Are you there?

6   A   I believe so.

7   Q   This is SoundExchange Exhibit 2239.

8   This is the e-mail that had forwarded that

9   Competitive Intelligence Report that we looked at.

10   The e-mail is from Ashley Hennings.   She

11   works in your group, right?

12   A   She does.

13   Q   It's to the executive leadership team at

14   Pandora, correct?

15   A   Yes, it appears to be.

16   Q   And that's you.   You're a part of the

17   executive leadership team, right?

18   A   I am.

19   MR. KLAUS: We move the admission of

20   Exhibit 2239, Your Honor.

21   MR. LARSON: No objection.

22   CHIEF JUDGE BARNETT: 2239 is admitted.

23   (SoundExchange Exhibit 2239 was

24   admitted into evidence.)

25

6152

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 1   BY MR. KLAUS:

 2        Q     And one of the things that Ms. Hennings

 3   says, she says "In Will's absence," that she

 4   "wanted to share the attached documents that our

 5   team has been developing and updating each

 6   quarter."

 7             The "Will," that's a reference to

 8   Mr. Valentine of your staff, correct?

 9        A     It is.

10        Q     Where she forwards a number of

11   documents, one of them is what's called "Fast

12   facts approved by public metrics."  Do you see

13   that?

14        A     I do.

15        Q     That would be what is behind tab 17,

16   SoundExchange Exhibit 2240?

17        A     Yes.

18        Q     Is that the fast facts public metrics

19   document that Ms. Hennings was talking about?

20        A     I believe it is.

21        Q     Another document that's developed and

22   updated by your team each quarter?

23        A     That's correct.

24             MR. KLAUS:  We move the admission of

25   Exhibit 2240, Your Honor.
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6153

1   MR. LARSON: No objection.

2   CHIEF JUDGE BARNETT: 2240 is admitted.

3   (SoundExchange Exhibit 2240 was

4   admitted into evidence.)

5   BY MR. KLAUS:

6   Q   One of the things you mentioned during

7   your examination by Mr. Larson was that Pandora

8   was trying to make a big move to the car, right?

9   A   Correct.

10   Q   And you know that Spotify is also trying

11 to integrate with carmakers as well, correct?

12   A   I am aware of that.

13   Q   Now, I would like to turn,

14 Mr. Fleming-Wood, to the subject of your

15 responsibilities as the head of marketing for

16 Pandora.

17   One of the things that you're

18 responsible for is something that you call growth

19 marketing, right?

20   A   Yes.

21   Q   And that's trying to expand your

22 audience and reach, correct?

23   A   Yes.

24   Q   And you're also responsible for what you

25 call brand marketing, right?

1   A   I am.

2   Q   And brand marketing refers to how the

3 consuming public, actual potential consumers

4 perceive the Pandora brand, right?

5   A   In part.

6   Q   And the person who runs that group for

7 you, her name is Melissa Waters, right?

8   A   Yes.

9   Q   And it's important to you what actual

10 and potential consumers think when they think of

11 Pandora, right?

12   A   Certainly.

13   Q   Because it's important to you that your

14 current active users, the 80 million of them,

15 think positively about the experience that they're

16 having on your site, right?

17   A   That would be the goal.

18   Q   Because you don't want to lose those

19 users, do you?

20   A   Of course not.

21   Q   You also think it's important what

22 prospective users, the people who haven't started

23 using the service, may think of when they think of

24 Pandora.

25   That's also an objective of marketing,

1   right?

2   A   Yes.

3   Q   If you could turn to tab 21. This is a

4   document, SoundExchange Exhibit 2356. First of

5   all, this was -- this was a document that was

6   created by Ms. Waters in your department, right?

7   A   I believe so, yes.

8   MR. KLAUS: We move the admission of

9   Exhibit 2356, Your Honor.

10   MR. LARSON: Objection. Lack of

11 foundation.

12   CHIEF JUDGE BARNETT: Overruled. 2356

13 is admitted.

14   (SoundExchange Exhibit 2356 was

15 admitted into evidence.)

16   MR. KLAUS: At this point, Your Honor,

17 I'm going to start going into the substance of the

18 document, which has been designated restricted, so

19 I think we do need to move into closed session.

20   CHIEF JUDGE BARNETT: Okay. Anyone in

21 the hearing room who has not signed the

22 nondisclosure certificate, please wait outside the

23 courtroom -- or the hearing room.

24   MR. LARSON: I assume it's okay if

25 Pandora staff stays.

6156

1   CHIEF JUDGE BARNETT: Except Pandora

2 staff may stay.

3   (THIS ENDS PUBLIC SESSION)

4   (RESTRICTED SESSION BOUND SEPARATELY)

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6193

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2   Q   Tab 13, this is Exhibit 1993 from the

3 Pandora blog. Is this something that your group

4 put out on the web about discovering more music

5 with personalized stations recommendations?

6   A   I don't know if we wrote it, but we

7 certainly would have a say on what went on the

8 blog.

9   Q   That is in or around this time frame in

10 2014, you rolled out more features related to

11 personalized station recommendations, correct?

12   A   It appears so, yes.

13   MR. KLAUS: We would move the admission

14 of 1993, Your Honor.

15   MR. LARSON: No objection.

16   CHIEF JUDGE BARNETT: 1993 is admitted.

17   (SoundExchange Exhibit 1993 was

18 admitted into evidence.)

19 BY MR. KLAUS:

20   Q   Then if you would take a look,

21 Mr. Fleming-Wood, behind tab 2, SoundExchange

22 Exhibit 404. This is another blog page talking

23 about the rollout of increased personalization

24 features, correct?

25   CHIEF JUDGE BARNETT: I'm sorry, if

1   these are blog pages, they can't be restricted,

2   can they?

3   MR. KLAUS: They're not restricted.

4   These are not restricted.   This is the last page

5   I'll talk about that's public, Your Honor.

6   CHIEF JUDGE BARNETT: Oh, I thought we

7   were in restricted.

8   MR. KLAUS: We are in restricted.   I

9   have no problem certainly, with this portion of

10   the transcript being -- and I can work with

11   Pandora's counsel to make sure that this portion

12   is designated public.

13   CHIEF JUDGE BARNETT: Okay, thank you.

14   MR. KLAUS: Thank you, Your Honor.

15   BY MR. KLAUS:

16   Q   Mr. Fleming-Wood, let me see if I can

17   ask the question again.   In or around January of

18   this year, it's a fact that Pandora rolled out

19   additional personalization features for its mobile

20   and Android listeners, correct?

21   A   This is a new UI for the app that's

22   announced in the second bullet post, so this is

23   just an updated UI for the app.   So, yes, we

24   introduced that and talking more about

25   personalization, but it was a redesign of the user

1   interface which we do from time to time.

2   MR. KLAUS: We move the admission of

3   Exhibit 404.

4   MR. LARSON: No objection.

5   CHIEF JUDGE BARNETT: 404, I'm sorry,

6   which tab was that?

7   MR. KLAUS: It was tab 2, SoundExchange

8   Exhibit 404.

9   CHIEF JUDGE BARNETT: Thank you. I was

10   on the last one.

11   Exhibit 404 is admitted.

12   (SoundExchange Exhibit 404 was

13   admitted into evidence.)

14   (THIS ENDS PUBLIC SESSION)

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23   (THIS ENDS RESTRICTED SESSION)

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25

1   (THIS BEGINS PUBLIC SESSION)

2   CHIEF JUDGE BARNETT: Mr. Miller, you

3 are on your feet.

4   MR. MILLER: I am, Your Honor. We have

5 the next witness so ...

6   CHIEF JUDGE BARNETT: All right. Who

7 would that be?

8   MR. MILLER: Mr. David Pakman.

9   - - -

10   DAVID PAKMAN,

11 having been duly sworn, testified as follows:

12   MR. MILLER: May I proceed?

13   CHIEF JUDGE BARNETT: Yes.

14   DIRECT EXAMINATION BY COUNSEL FOR iHEARTMEDIA

15 BY MR. MILLER:

16   Q   Good afternoon, Mr. Pakman.

17   A   Good afternoon.

18   Q   Mr. Pakman, where are you currently

19 employed?

20   A   I'm a partner at Venrock.

21   Q   What is Venrock?

22   A   Venrock is a venture capital firm. It's

23 one of the oldest capital venture firms that was

24 established in the late 1930s by Laurance

25 Rockefeller. Venrock is actually a compound word

1 combining "venture" and "Rockefeller." We invest

2 in early-stage technology in healthcare companies

3 and try to grow them into big successful

4 companies.

5   Q   Can you give us some examples of some of

6 the companies Venrock has invested in.

7   A   Yes, over the more than 40 years, we've

8 invested in companies like Apple, Intel, and

9 companies like Cerna Pharmaceuticals and Check

10 Point and DoubleClick.

11   Q   How long have you worked at Venrock?

12   A   I will have been there seven years this

13 November.

14   Q   While at Venrock, do you have any

15 personal experience with digital music companies?

16   A   Given my background as an entrepreneur

17 and executive in digital music, I am the point

18 person at Venrock for reviewing business plans or

19 investment opportunities from start-up seeking

20 investment. Over my almost seven years there,

21 I've reviewed scores maybe every year of companies

22 in digital music.

23   Q   Can you describe briefly what some of

24 your review of those companies involves?

25   A   Yes, when I review any potential

1 investment, we meet with the -- often meet with

2 the teams, review the P&Ls and investment plans,

3 look at the business plan, make an assessment of

4 the market, look at some other materials, maybe

5 some research to try to figure out whether there's

6 a good opportunity for investment.

7   Q   You mentioned a moment ago that you had

8 some background before Venrock. Did you have any

9 experience in digital music before you came to

10 Venrock?

11   CHIEF JUDGE BARNETT: Excuse me,

12 Mr. Miller, should we open the hearing room?

13   MR. MILLER: I think we'll be in public

14 session for the whole time.

15   CHIEF JUDGE BARNETT: Okay. Thank you.

16 BY MR. MILLER:

17   Q   I was asking about your background prior

18 to Venrock.

19   A   Yes, before Venrock, I started my career

20 at Apple where I was the co-creator of Apple's

21 early efforts in music, the Apple music group.

22 After that, I was an entrepreneur three different

23 times, helping build or founding or running three

24 different digital music companies.

25   Q   Can you identify a couple of digital

6210

1   companies and what they did?

2   A   Sure. One of them was a company called

3   MyPlay. I was the co-founder of that and its

4   president. That was a digital music locker

5   company. It was also one of the very first

6   commercial webcasters, operated a webcasting

7   service. I also was the CEO of eMusic, one of the

8   largest independent retailers of digital music,

9   where I negotiated thousands of royalty agreements

10   with record labels, music publishers and

11   performing rights societies, and built and

12   launched a service that was in use by millions of

13   consumers.

14   Q   Shifting gears a little, have you ever

15   testified before related to digital music or

16   licensing?

17   A   I have. I was an expert witness in the

18   first CARP rate-setting hearing related to

19   Internet webcasting, and I also testified in front

20   of Congress on some proposed legislation around

21   Internet radio.

22   MR. MILLER: Your Honor, we offer

23   Mr. Pakman as an expert in investment in the

24   digital music industry.

25   MR. KLAUS: I would certainly have no

6211

1   objection to Mr. Pakman as an expert on the

2   subject of venture capital investment, which I

3   think is the only thing that the examination so

4   far has provided a foundation for. On the subject

5   of investment more broadly, I don't think he's

6   qualified as an expert on that subject.

7   MR. MILLER: Your Honor, he testified,

8   we can have him testify more about he's got

9   experience both as an investor, as a venture

10   capitalist, but also within the digital music

11   industry itself.

12   CHIEF JUDGE BARNETT: You'll need to lay

13   a little more foundation for that broader

14   definition of investment. Certainly he is

15   qualified as a venture capital and investment

16   professional in the industry, but if you would --

17   if you want a broader qualification, you need to

18   establish it.

19   MR. MILLER: Sure.

20   BY MR. MILLER:

21   Q   In reviewing financials or in reviewing

22   companies, can you describe some of the principles

23   that you applied to review digital music companies

24   more generally.

25   A   Yes. Typically in evaluating whether an

1   investment opportunity is attractive, we'll look

2   at the economic structure of a company, what are

3   its likely revenues, what are its gross margins,

4   what are its chance for profit, how large is the

5   market, is the market growing, how challenging is

6   it to bring the product to market, are there

7   certain impediments to bringing -- making the

8   company successful.

9   Prior to running music, I was a partner

10 at a private equity firm called Dimensional

11 Associates. It's a little bit different than

12 venture capital. There we were taking control

13 positions. We were purchasing stand-alone

14 companies. In that case, I had to evaluate

15 whether we wanted to be an entire owner of a

16 company and run it ourselves, a little bit

17 different job than venture capital, but also in

18 the field of investing in digital music.

19   Q   Do you do anything in your job to follow

20 the digital music industry and the economics of

21 it?

22   A   Yes, given that I spent almost 15 years

23 as an entrepreneur in it, it's an industry that's

24 near and dear to my heart. I love music. So I

25 have stayed very close to it. I read research

1 reports and talk to fellow venture capitalists and

2 entrepreneurs about this case in hopes of turning

3 that expertise into a chance to invest in a

4 company to can grow and be successful.

5   MR. MILLER: We would offer him based on

6 the additional testimony he's given as an expert

7 in the economics of the music industry --

8 investment in the economics of the investment --

9 in the music industry.

10   MR. KLAUS: It would be the same

11 objection, Your Honor. I think what Mr. Pakman

12 has testified to is his experience and his breadth

13 of experience and discussions with people in the

14 venture capitalist space. Again, no objection to

15 him being qualified to talk about that. But in

16 terms of what sort of broader investments are made

17 in digital music, I don't think he's been

18 established as an expert.

19   CHIEF JUDGE BARNETT: I heard testimony

20 about investment as in taking an ownership

21 interest. That's not the same as a venture

22 capital owner. Overruled. Mr. Pakman is so

23 qualified.

24   MR. MILLER: Thank you, Your Honor.

25

6214

1 BY MR. MILLER:

2   Q   I should have mentioned we placed a

3 binder in front of you, Mr. Pakman, as well as the

4 court. If I could ask you to turn to the first

5 tab of that binder. Do you recognize that

6 document?

7   A   I do.

8   Q   What is it?

9   A   This is my direct testimony.

10   MR. MILLER: Your Honor, we move into

11 evidence what I think is identified as IHM Exhibit

12 3216.

13   MR. KLAUS: No objection.

14   CHIEF JUDGE BARNETT: 3216 is admitted.

15   (IHM Exhibit 3216 was admitted into

16 evidence.)

17 BY MR. MILLER:

18   Q   Mr. Pakman, do we have a demonstrative

19 that also summarizes your testimony in your

20 written direct?

21   A   Yes, I believe you do.

22   Q   Can we put that up on the screen.

23   Do you intend to cover all the details

24 of your opinions today?

25   A   No.

1   Q   On this demonstrative you used the term,

2 so we use the same terminology, the term

3 "webcaster." What do you mean by the term

4 "webcaster" here?

5   A   I define a webcaster as a service that

6 avails themselves of the statutory license and

7 operates a webcasting service. I use also the

8 term "stand-alone webcaster" here. I mean that to

9 mean a company whose primary or exclusive business

10 is operating a webcasting service as opposed to

11 additional businesses like selling of phones or

12 providing software to listeners.

13   Q   In your experience in the digital music

14 industry or investment, are you aware of any

15 profitable webcasters?

16   A   No, I've never seen or met with or

17 reviewed a single company in webcasting as

18 profitable.

19   Q   What is the basis for your experience to

20 say that there are no profitable webcasters?

21   A   Well, one, I operated a webcaster

22 originally. Two, as part of my job as a venture

23 capitalist, as I mentioned earlier, I met with

24 scores of companies and evaluated their prospects

25 of being profitable. None of them were

1 profitable. And to my knowledge, none of them

2 have achieved profitability.

3   Q   In your experience, what's the reason or

4 the most significant reason for the lack of any

5 profitable webcasters?

6   A   Well, the highest cost, the largest cost

7 that any webcaster faces are the sound recording

8 royalties. So their ability to be profitable or

9 not is a direct result of the royalties they pay.

10 In fact, we can look at this as gross margin. The

11 higher royalties they pay, the lower their gross

12 margin. Lower gross margin companies have a

13 harder time becoming profitable. So in this

14 example, lower royalties would mean higher gross

15 margins and would offer a company a higher chance

16 of being profitable.

17   Q   Do you understand that there have been

18 witnesses on the other side who filed testimony in

19 response to your opinions?

20   A   Yes.

21   Q   Have you read the testimony of Professor

22 Lys responding to you?

23   A   I have.

24   Q   And are you aware that he claims that,

25 for instance, Pandora's recent performance in the

6217

1   fourth quarter of 2014 demonstrates that, in fact,

2   webcasters can be profitable?

3   A   Yes, I've read that.

4   Q   Do you have a response?

5   A   To the best of my knowledge, Pandora has

6   never been profitable on an annual basis up until,

7   I believe, Q4 of last year, that would have been

8   the first quarter they ever turned a profit. That

9   profit was a small profit. It was 12 million

10   dollars. But I see already that in Q1 of this

11   year, they have flipped back to being

12   unprofitable. In fact, I believe their loss was

13   48 million dollars, four times the profit in Q4 of

14   last year.

15   And the research reports I read by

16   public market stock analysts, none of them, those

17   analysts that I read, believe that Pandora will

18   ever be profitable on an annual basis. So

19   Professor Lys's pointing out they achieved one

20   profitable quarter doesn't change my point of

21   view.

22   In addition, Pandora is a company that

23   pays rates lower than the commercial CRB rates.

24   In the event that their rates were to raise, I

25   think that would have an impact on their ability

1   to be profitable. So I don't have hopes for that

2   company to be profitable from everything that I

3   see.

4   Q   What is your understanding of the rates

5   as compared -- that Pandora pays as compared to

6   the CRB rates?

7   A   I believe their rates are about 50 or 60

8   percent that of the commercial CRB rates.

9   Q   To your knowledge, has anyone in the

10   case suggested that a webcaster has managed to

11   make a profit at the roughly double CRB rates?

12   A   No, I haven't seen anyone make that

13   statement.

14   Q   You talked a good deal in your testimony

15   about gross margins and you mentioned it earlier,

16   but have you read Professor Lys' testimony that

17   Pandora's gross margin is higher than the margin

18   for some of the companies that you would deem

19   successful?

20   A   Yes, I read that.

21   Q   What would you say in response to that?

22   A   Well, first of all, I believe Pandora's

23   margins vary quite a bit over the years quarter to

24   quarter. So some margins -- some quarters, their

25   margins -- gross margins are lower than other

1 quarters. In addition I think that what matters

2 really here is whether the company can ever be

3 profitable. Professor Lys, I believe, pointed out

4 a company or two that has achieved profitability

5 but has gross margin similar to Pandora's. I

6 think my point is the lower the gross margins, the

7 less likelihood that you can be profitable. And

8 the fact that Pandora's had varied, some quarters

9 good -- some quarters higher, some quarters lower,

10 hasn't had any bearing on their ability to turn

11 profit on an annual basis.

12   Q   Professor Lys also asserts that

13 short-term profitability is not an adequate

14 measure of success in this nascent industry

15 because firms might be trying to refine their

16 business models or achieve critical mass. Have

17 you seen that?

18   A   Yes, I've seen that.

19   Q   Do you agree with that assertion?

20   A   I don't. I don't agree, no.

21   Q   Why not?

22   A   Well, first of all, I think webcasting

23 is not an nascent industry. It's an industry

24 that's been around 14, 15, 16 years. One would

25 expect, particularly when you're looking to

1   determine whether an industry is predictive of

2   success, is it likely to be able to produce

3   positive investment outcomes for investors, that

4   you would see some evidence of profitability. We

5   would see some of the hundreds of companies who

6   have become webcasters over the years that they've

7   been able to achieve profitability. Yet we can't

8   find a single one that's profitable. So I don't

9   think there is strong evidence that we're going to

10   find that, first of all.

11   Second, I think that Professor Lys

12   suggested, I think the strategy that Pandora's

13   applying is one of foregoing profits in exchange

14   for growth. So if that were true, then I guess we

15   would expect that since no companies are

16   profitable in webcasting but they must all be

17   employing the strategy and that none of them are

18   attempting to be profitable. But that would mean

19   one of two things that would need to be true then,

20   that everyone would be big. That's not the case.

21   We have hundreds of very small webcasters who are

22   unprofitable. We've got a couple big ones and

23   they're unprofitable.

24   But it would also then have to be true

25   that Pandora, whose now growth has slowed compared

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1   to what it's been over the previous years, maybe

2   then they would profitable now, but even they're

3   not. So I don't believe that it's an accurate

4   assessment to say that every webcaster is

5   foregoing profit.

6   Q   Have you seen any examples of companies

7   who were pursuing a different business model or

8   strategy than Pandora who are profitable?

9   A   No, I have not.

10   Q   I'll turn to a slightly different topic.

11   Did you offer some opinions in your

12 written testimony about the lack of meaningful

13 entry into the webcasting industry?

14   A   Yes.

15   Q   Is that discussed in more detail in your

16 report?

17   A   Yes, I set that forth in my written

18 direct testimony.

19   Q   Can you summarize your opinion?

20   A   Yes. So my testimony there discusses

21 that -- well, first, I think it's probably helpful

22 to say venture capitalists have a fixed amount of

23 money to invest. So we review investment

24 opportunities in many different sectors.

25   So what I did in my research was to

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1 compare the digital music sector, the number of

2 venture-backed companies that have been started

3 there with the many other sectors into which we

4 can invest our capital. The data there showed

5 that there is a very small number of

6 venture-backed digital music companies, webcasters

7 would be a subset of those, that have entered the

8 market over a period of 17 years or so, and yet

9 there are many other industries where there have

10 been literally orders of magnitude more

11 venture-backed companies that have entered the

12 space.

13   So the conclusion in my testimony is

14 that there's actually on a relative basis very few

15 venture-backed digital music companies, and,

16 again, webcasters would be a subset of those.

17   JUDGE STRICKLER: I wanted to ask,

18 excuse me, a question in that regard. If I

19 understand your testimony just now, you were

20 basically comparing the success and failure rates

21 in digital music that was financed by venture

22 capital, that's on page 13 in subparagraph (a) of

23 your written direct testimony, with what you have

24 in your comparative other market segments in

25 subparagraph (b), right?

1   THE WITNESS: Yes.

2   JUDGE STRICKLER: So going back to

3   subparagraph (a), you say there were 175 digital

4   music companies that were created and funded by

5   venture investors, right?

6   THE WITNESS: Yes.

7   JUDGE STRICKLER: Then you say, "Of

8   those approximately 33 percent were acquired by

9   larger companies."

10   THE WITNESS: Yes.

11   JUDGE STRICKLER: Are you categorizing

12 the 33 that were acquired by larger companies as

13 those who failed and exited or in some other way?

14   THE WITNESS: In the footnote below,

15 footnote number 32, I believe, I explained that

16 not all 33 of those were characterized as

17 successful outcomes because some of them were -- I

18 characterize them as either failed or a success.

19 So some portion of the 33 were successful, but not

20 all, because a few of them were acquired for less

21 money than their venture investors put in.

22   JUDGE STRICKLER: Is that the way we

23 should be measuring whether they're successful or

24 not, as to whether the investors received a return

25 on investment? If they're still in business, are

6224

1 you saying that if the investors didn't get a

2 return, a positive return, that they should be --

3 I understand from your point of view they would be

4 deemed as failures. But from our point of views,

5 why should we deem them as failures if they're

6 still operating?

7   THE WITNESS: One of the reasons why I

8 think the data that I show in my testimony is what

9 it is, why there are so few digital music

10 companies backed by venture investors compared to

11 these other segments is because so few of them are

12 successful, as I think the data I prepared show

13 that digital music companies have a failure rate

14 two times as high as other sectors. And these

15 other sectors have a success rate, that is they're

16 likely to produce a profitable outcome for their

17 investors at least six or seven times more

18 frequently than digital music companies. So the

19 reason I think that's relevant to you is if that

20 continues, there will be less and less attractive

21 investment opportunities for investors, investors

22 won't fund digital music companies. There will be

23 fewer and fewer of them created, which I think can

24 lead to an unhealthy market.

25   JUDGE STRICKLER: Help me. I realize

6225

1 it's in the footnote, but maybe you can give me

2 the snapshot because I'm trying to compare the

3 success and failure rates of paragraphs (a) and

4 (b). Of the 33 that were acquired by larger

5 companies, how many of those would you say were

6 successful by your measurement?

7   THE WITNESS: I said -- I have an

8 additional footnote. I believe it is 7, "Produced

9 profitable outcomes to their investors."

10   JUDGE STRICKLER: So the next sentence

11 where you say "of those who have exited," that's

12 making reference back to those 33? Or is that

13 just a coincidence?

14   THE WITNESS: Yes, the data showed that

15 36 companies had non-distressed exits, that means

16 they didn't go bankrupt. They were acquired. So

17 then I parsed to try to figure out how many of

18 those resulted in profitable exits for investors.

19 And here I say that I removed a few because they

20 weren't -- they did not exit. That was 33.

21 Then --

22   JUDGE STRICKLER: So those 33 are --

23   THE WITNESS: In the testimony, though,

24 in subparagraph (a) --

25   JUDGE STRICKLER: Right.

1   THE WITNESS: -- I list, of those who

2   have exited, only 7 achieved meaningful venture

3   returns for their investors.

4   JUDGE STRICKLER: Maybe I'm just missing

5   it, maybe it's late in the afternoon, but of the

6   33 that were acquired by larger companies, are you

7   saying that those 33 are part of the failures --

8   THE WITNESS: No.

9   JUDGE STRICKLER: -- or the successes?

10   Or they're split? If they're split, what's the

11   issue?

12   THE WITNESS: Seven of the 33 produced

13   meaningful returns for their investors. I list

14   them above.

15   JUDGE STRICKLER: Thank you.

16   THE WITNESS: Yes.

17   BY MR. MILLER:

18   Q   Did you compare the success and failures

19   to other industries in your testimony?

20   A   I did, yes.

21   Q   How did those compare?

22   A   As I just mentioned, the results show

23   that there are somewhere between ten times and 45

24   times the number of companies created in other

25   sectors I looked at, such as mobile, eCommerce, or

1 SaaS compared to digital music, and that digital

2 music companies are twice as likely to fail than

3 these other sectors. The other sectors are six to

4 seven times more likely to produce a profitable

5 outcome for their investors.

6   Q   Now, have you also reviewed the

7 testimony of Professor Lys responding to you and

8 discussing the entry by larger firms like Apple or

9 Google into the webcasting industry?

10   A   Yes.

11   Q   Does the entry of entities like that

12 change your opinions as to whether there's been

13 meaningful entry?

14   A   Well, I look to see whether there's

15 opportunity for venture-backed investments to

16 occur. Obviously if all the entry in the market

17 is coming from companies that are already public,

18 there's no venture-backed opportunities to enter.

19 Also, I think those companies, you know, may be

20 pursuing investment or maybe pursuing investment

21 or activity in the space for different reasons

22 than what a venture investor is looking for.

23 We're looking to make a profitable return. So I

24 don't think the comparison is relevant.

25   Q   Do you view the existence of entities

6228

1 like Apple or Google in the market as a sign of a

2 healthy digital music market?

3   A   No. I think, in fact, there's some

4 evidence that those companies operate music

5 services unprofitably and are content with

6 subsidizing the music service operations with

7 profits made elsewhere in their business, which I

8 view as a sign of an unhealthy market and

9 certainly something that would discourage further

10 entry by companies trying to make a profit.

11   Q   Now, are you aware that Professor Lys

12 also characterizes the number of digital music

13 investments that you identified in your testimony

14 as being substantial and states that for those

15 paying the statutory rates, they must have

16 concluded that the royalties did not prevent them

17 -- prevent their chances of success?

18   A   I'm aware of that.

19   Q   Do you have a response that?

20   A   Yes, first of all, the 175 that I

21 identified are digital music venture-backed

22 companies. They're not all webcasters.

23 Webcasters would be a subset of the 175. Of the

24 subset of the 175 who are webcasters, a further

25 subset of them would be the ones paying the

1 commercial CRB rates. There are some smaller

2 number of companies that we're talking about here

3 that are relevant to this discussion about

4 webcasters.

5   Q   Do you view that subset as healthy

6 compared to other industries?

7   A   Yes, the numbers show it's an extremely

8 small number. I mean, taken as a whole and

9 looking at venture activity around the United

10 States or around the world, it's literally orders

11 of magnitude, more capital are going into many,

12 many other tech sectors that are much more

13 vibrant, producing -- more entrepreneurs are

14 entering, more investment dollars are going in,

15 more exits are happening. They're a vibrant

16 industry. This is not one of those. In fact,

17 it's surprising how few companies we're talking

18 about here on a relative basis.

19   CHIEF JUDGE BARNETT: Sorry, could you

20 tell me what a digital music business would do if

21 it's not doing webcasting?

22   THE WITNESS: Sure, interactive service,

23 for example, interactive streaming service like

24 Spotify.

25   CHIEF JUDGE BARNETT: Okay. Would that

1   include reproduction of music?

2   THE WITNESS: Yes, like iTunes would

3   also be an interactive music service, whether it's

4   doing digital downloads. 175 is people who are in

5   the business of licensing music content and

6   somehow selling it or providing a service to

7   consumers.

8   CHIEF JUDGE BARNETT: Okay, I'm now

9   reminded your definition of webcasting is the

10 statutory license services.

11   THE WITNESS: Yes, a subset of the ones

12 that --

13   CHIEF JUDGE BARNETT: Thank you.

14   JUDGE FEDER: Would you include in your

15 definition of webcasting companies that are paying

16 the pureplay settlement rate as well?

17   THE WITNESS: They would be included in

18 -- for purposes of this discussion, I've said

19 webcasters are people availing themselves of the

20 statutory rate. But some subset of all people who

21 webcast pay the statutory rate and others pay on a

22 voluntary commission.

23   JUDGE FEDER: You're including that

24 whole group?

25   THE WITNESS: In the 175, yes.

1   JUDGE FEDER: Thank you.

2   BY MR. MILLER:

3   Q   In addition to the response about the

4   overall numerical number of entries, Professor Lys

5   also notes to you in this -- is the reliance on

6   Dr. Blackburn that there's been investments of 2.4

7   billion dollars in the music industry. Do you

8   recall that?

9   A   I recall his reference to that, yes.

10   Q   Does that reference to that amount of

11 investment change any of your opinions?

12   A   No, it doesn't, for a number of reasons.

13 One, the 2.4 billion number is not representative

14 of what we're discussing here. I believe if you

15 look closer at those numbers, of the 2.4 billion

16 of investments made into music and other

17 entertainment services, only, I think, 432 million

18 went into Internet radio, which also would be the

19 same superset of people paying statutory rate and

20 maybe not paying statutory rate. Of the 432

21 million, I believe 393 million went into Pandora,

22 so that was one company that received the

23 investment. I believe the other, the remaining

24 balance of the Internet radio went to three

25 companies. One of them, I believe, was TuneIn,

1   which received about 25 million dollars. To the

2   best of my knowledge, they're an aggregator of

3   other streams. They don't even pay royalties.

4   They wouldn't meet my definition of webcaster.

5   Another is Songza, which I believe

6   received an investment of about 4 and a half

7   million dollars. It was a very small webcaster

8   that was acquired by Google for 15 million dollars

9   which would not be considered a successful

10   venture-backed outcome.

11   Finally, I think the last company in

12   this 113 million was DeliRadio, I think. I

13   believe they also don't pay royalties. They

14   license promotional use of songs directly from

15   artists and small record labels.

16   Q   I won't go through them all, Professor

17   Lys lists a number of other investment -- or,

18   excuse me, digital music companies in his

19   testimony. Have you seen that?

20   A   I have, yes.

21   Q   Do any of those change your opinions?

22   A   They don't change my point of view

23   because, quite frankly, there are a lot of

24   different companies in there that aren't relevant

25   to this discussion. For instance, some were

6233

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 1   companies based in France that don't even operate

 2   in the United States.  Some of them have been shut

 3   down.  I don't know what rates some of them pay.

 4   I don't know if they're voluntary.  Many of them

 5   were not webcasters.  They were interactive music

 6   services, operating under negotiated licenses.  So

 7   it didn't change my point of view about my

 8   testimony.

 9        Q    You didn't list it in your testimony,

10   some specific examples of failed companies.  Do

11   you recall that?

12        A    Yes.

13        Q    Was one of those Yahoo?

14        A    Yes.

15        Q    Are you aware --

16        A    Just for clarity, Yahoo's music efforts,

17   not Yahoo as a whole.

18        Q    Fair clarification.

19             Are you aware that Professor Lys

20   criticized you for some of the sources you cited

21   related to Yahoo?

22        A    Yes.

23        Q    Do you have a response to that?

24        A    I do.  Yahoo was in several different

25   segments of the digital music business and they
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6234

1 exited those segments three different times. In

2 2002 they exited their simulcast business. In

3 2007 they exited their Music Match, interactive

4 music product. In 2008 they exited their

5 webcasting business by selling it off to CBS.

6   So in the public reports, they made very

7 clear that they exited in, at least 2007 and 2008,

8 those businesses because of high royalty rates.

9 They were unable to earn a profit. I'm very

10 familiar with Yahoo's management decisions and

11 point of view, and their view is consistent

12 throughout operating all of these businesses that

13 a major, if not the primary, reason they exited

14 was because their rates were too high and they

15 were unable to earn a profit.

16   Q   In light of the evidence that you've

17 seen, what is your view of the health of the music

18 -- digital music industry?

19   A   I don't believe it's a healthy industry.

20 I don't believe it attracts significant amounts of

21 venture capital. I don't believe it attracts a

22 significant amount of entrepreneurs who are

23 willing to start companies, build them, owing to

24 high royalty rates. The high royalty rates are

25 stifling the companies' ability to turn profits.

6235

1   They're making it impossible for companies to be

2   profitable. As a result, we see it as a very

3   unattractive segment into which to make

4   investments.

5   MR. MILLER: No further questions at

6   this time.

7   CHIEF JUDGE BARNETT: Thank you.

8   Mr. Klaus.

9   MR. KLAUS: Thank you, Your Honor.

10   CROSS-EXAMINATION BY COUNSEL FOR SOUNDEXCHANGE

11   BY MR. KLAUS:

12   Q   Hi, Mr. Pakman. We haven't met. I'm

13   Kelly Klaus. I represent SoundExchange. I know

14   that we can't keep you over tonight, so let's try

15   our best to get this done in just, say, a couple

16   minutes.

17   A   Thank you.

18   Q   Mr. Pakman, just so we're clear, your

19   opinion is that venture capitalists don't like

20   investing in webcasters and other digital music

21   services, right?

22   A   Relative to other industries.

23   Q   Because those -- the economics of the

24   webcasting digital music service, those don't

25   allow venture capitalists to make venture returns,

6236

1 right?

2   A   The royalty rates that webcasters and

3 digital music companies pay don't allow them to

4 become profitable, and as a result, venture

5 investors are less likely to have a profitable

6 outcome on their investments.

7   Q   And by profitable outcomes, you said

8 that Songza's acquisition by Google for 15 million

9 dollars on a 4 million dollar investment, your

10 view is that is not a successful venture-backed

11 outcome, right?

12   A   By venture capitalist standards, that's

13 not a successful outcome.

14   Q   At a return of more than 3 to 1, that's

15 not a successful outcome by venture capitalist

16 standards, right?

17   A   It's less about the cash on cash return

18 rate and it's about the magnitude of the dollars.

19 So 10 million dollars of profit on 4.7 million

20 dollars of investment doesn't sustain the venture

21 capital model of many venture investors.

22   Q   One of the reasons that you don't like

23 investing in digital music services is you don't

24 like investing in businesses that have to get

25 somebody else's permission to operate, correct?

6237

1   A   I believe that -- well, the primary

2 reason why I don't like investing in digital music

3 is because they can't be profitable. But I do

4 believe that negotiated voluntary licenses can

5 take a long time to get and can make operating a

6 business more difficult.

7   Q   You don't like investing in the

8 businesses whose owners have to ask someone else

9 for permission to use their content; isn't that an

10 opinion you've expressed before?

11   A   I believe that it makes it more

12 challenging to operate businesses.

13   Q   Your view is that if people who are

14 entrepreneurs who want your VC money need to get

15 rights from someone else, that's too much of a

16 risk for you to take, right? That's an opinion

17 you expressed previously?

18   A   I expressed an opinion that it's

19 riskier. I never said it was too much of a risk

20 to take.

21   Q   Let's see. Did you speak at something

22 called the CoInvent Summit last December?

23   A   I may have.

24   Q   Could we take a quick look at what you

25 said there.

6238

1   Mr. Nickels, if you could just play

2   that.

3   (Video played as follows:)

4   MR. PAKMAN: The last thing I'll say, I

5   think this is an important statement for

6   entrepreneurs, we invest in businesses that are

7   not permission-based businesses. What that means

8   to us is that you as the entrepreneur don't have

9   to ask someone else's permission for you to

10 succeed. Since we're backing great teams that are

11 going after really interesting products in big

12 markets, we want you to have the freedom to

13 operate. In license entertainment models, movies,

14 TV, music, you almost always can't bring your

15 product to market without going and getting the

16 rights holder's permission.

17   So in many cases the rights holder

18 controls your destiny. That's too much of a risk

19 for us to take because they're often not rational

20 actors, at least as it relates to your success.

21 So pretty much everyone else on the Internet, from

22 casual games to marketplaces, you don't need the

23 permission of an oligopoly to succeed. And I

24 would encourage entrepreneurs to look for the

25 rights base in non-permission because it's

6239

1   unnecessarily harsh to attach your entire future

2   on the decisions of a couple highly paid

3   executives.

4   VOICE: Your advice is do not ask for

5   permission as for PMS?

6   MR. PAKMAN: Well, actually, my advice

7   is don't go into industries where you have to ask

8   permission. If you have to ask permission, then

9   the question is do you ask permission or do you

10 ask for -- beg for forgiveness. That's a

11 different strategic question. I'm telling you,

12 don't even get to the point that you ask yourself

13 that. Go into industries where you don't have

14 that.

15   (End of video.)

16 BY MR. KLAUS:

17   Q   Mr. Pakman, while you say venture

18 capitalists aren't investing in the webcasting

19 digital music space, other entities are investing,

20 right?

21   A   I'm not sure.

22   Q   Well, let's take Apple, for example.

23 They bought Lala in 2009, correct?

24   A   Yes.

25   Q   That was something you wrote on your

6240

1   blog, that you were shocked that they would do

2   that, right?

3   A   Yes.

4   Q   But they did it, correct?

5   A   They did.

6   Q   They developed and launched the iTunes

7   Radio service in 2013, correct?

8   A   Yes, they did.

9   Q   They bought Beats in 2014, correct?

10   A   The headphone company.

11   Q   The headphone and digital music company,

12   correct?

13   A   I believe they bought the 99 percent of

14   headphone company, yes.

15   Q   They paid 3 billion dollars for the

16   collective assets of that company, right?

17   A   I think so, yes.

18   Q   You've read news reports, I take it, in

19   following this space that Apple is preparing to

20   relaunch a Beats music service, right?

21   A   Yes, I have read those.

22   Q   And Google, Google has invested a

23   significant amount of money into the Google Play

24   service, correct?

25   A   I don't know.

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 1      Q     You're aware they have a streaming music

 2   service, correct?

 3      A     I am.

 4      Q     Amazon also provides a streaming music

 5   service, correct?

 6      A     Yes.

 7      Q     Those companies, they make -- they have

 8   each made a decision that they're willing to do

 9   business in this space because they think it's in

10   the best interest of their company, correct?

11      A     I can't tell you the reasons why they

12   have decided to go into these spaces.  I don't

13   know.

14      Q     You're not privy to their

15   decision-making, correct?

16      A     As a whole, no.  I have isolated

17   examples of having spoken with a few different

18   executives at those companies, but I can't tell

19   you -- agree or disagree with your statement as to

20   why they have decided to go into them.

21             JUDGE STRICKLER:  In your testimony,

22   though, in paragraph 28, don't you say that one of

23   the reasons there have been sales to larger

24   companies is "that they're willing to subsidize

25   the poor economics in order to make profit
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6242

1 elsewhere on other related businesses?"

2   THE WITNESS: Yes, and I believe that's

3 one reason why they enter these spaces, but in

4 answering that question, I don't think I could

5 generally say yes, that I know why they're going

6 into these spaces. I think that's a plausible

7 reason for why many do enter the space.

8   JUDGE STRICKLER: You refer to it as

9 subsidizing the poor economics, but another spin

10 on that certainly would be that they're willing to

11 invest in the noninteractive space, right, in

12 order to get greater returns on other lines of

13 business that they have so it becomes a net

14 positive return on investment or so they would

15 project, which is why they go into it. Isn't that

16 just another form of investment?

17   THE WITNESS: I believe that their

18 willingness to operate unprofitable businesses is

19 because it provides them some benefit in some

20 other part of their company for sure. I don't

21 know that the reason they're willing to invest in

22 the digital music business is because they believe

23 the digital music business themselves will be

24 profitable someday. I don't think there's clear

25 evidence of that.

6243

1   JUDGE STRICKLER: Thank you.

2   BY MR. KLAUS:

3   Q   Let's go beyond the

4   Apple/Google/Amazons.   Spotify, you're aware they

5   recently raised 400 million dollars in funding?

6   A   Yes.

7   Q   And Goldman Sachs participated in that

8   investment round; you're aware of that, right?

9   A   Yes.

10   Q   The Abu Dhabi Sovereign Wealth Fund

11   participated in that 400 million dollar offering,

12   right?

13   A   I don't know.   If you say so.

14   Q   Have you read reports that they did?

15   A   I just don't recall who all their

16   investors were in the last round.

17   Q   And iHeart, the same company that's

18   hired you to testify here, they bought the thumb

19   play music service in 2011, correct?

20   A   Yes.

21   Q   They've developed and launched the

22   iHeartRadio custom radio offering, right?

23   A   Yes.

24   Q   They've made a business decision to run

25   iHeartRadio, custom radio without ads, correct?

6244

1   A   I can't say for sure. I honestly don't

2 know.

3   Q   But they -- obviously they made a

4 decision that it's in the best interest of their

5 company to pursue this business, right?

6   A   I think there's a -- you know, you can

7 find several examples of companies willing to

8 invest in the space. What I think you can't find

9 is examples of hundreds of thousands of companies

10 entering. You can't find evidence of venture

11 capitalists investing significant money in the

12 space compared to other industries.

13   So I think you're -- by picking one or

14 two or three examples, you're finding exceptions

15 that prove the rule, that there is a very limited

16 amount of investment made by venture capitalists

17 and that's the three or four giants you can name

18 who invest in the space do so for reasons other

19 than finding a reason for profit.

20   JUDGE STRICKLER: Mr. Pakman, a question

21 for you. Do you think that Pandora's large market

22 share in the noninteractive space makes it a

23 potentially good acquisition target for some of

24 these larger players?

25   THE WITNESS: I don't know. I believe

1 that market share for some of these companies,

2 like Apple and Google, is important because they

3 are trying to maximize consumer attention on their

4 devices. And I believe that Pandora has created

5 value by being -- value potentially to some

6 acquirer by being large, but I think they've also

7 made their business -- their business is

8 unattractive because it seems spreadingly unable

9 to be profitable.

10   JUDGE STRICKLER: Unable to be

11 profitable, and that's the example of the poor

12 economics that you say exist given the royalty

13 rate structure?

14   THE WITNESS: Yes. I mean, they pay

15 rates less than the commercial CRB. They can't be

16 profitable -- have not been able to be profitable

17 under those rates and rates continue to go up and

18 so their prospects for profitability seem

19 unlikely.

20   JUDGE STRICKLER: But other large

21 companies have acquired noninteractive and other

22 streaming services despite the fact they're not

23 making any money. So is it your testimony that

24 Pandora's lack of profitability is unusual in that

25 it makes Pandora not a good acquisition target?

1   THE WITNESS: I think it would be hard

2   to argue with the fact that profitable companies

3   are more appetizing acquisition targets than

4   nonprofitable ones.   But the fact that

5   unprofitable ones get bought doesn't mean that

6   unprofitable ones have no appeal to books, right?

7   JUDGE STRICKLER: More profitable ones,

8   you have to pay more of a premium for, right?

9   THE WITNESS: Perhaps, yes, I would

10   think so.

11   JUDGE STRICKLER: So unprofitable means

12   that you can buy it at a relative bargain if you

13   can create synergies in your own business because

14   you have other larger businesses --

15   THE WITNESS: I can think of big

16   premiums who pay for unprofitable companies from

17   time to time, too.   So I can't draw the exact same

18   point that you're making.   But I certainly do

19   believe that there are examples, really in the 20,

20   30, 40 range, I think 33, of companies that get

21   bought in this space.   But on a relative basis,

22   compared to mobile or social networking or

23   eCommerce or enterprise SAS, they're dwarfed by

24   literally one or two orders of magnitude.

25   So I think the fact that we could find a

6247

1 few examples of two companies that got bought is

2 not indicative that it's healthy, and I think,

3 furthermore, it proves my point, that this is not

4 a fertile industry that attracts venture capital

5 investment in the same way that so many others do.

6 And the reason I think that's relevant is because

7 we as CVs make a choice every day where we're

8 going to invest, and we are drawn to investment

9 where there's a higher likelihood of success. As

10 long as rates are high, I think that makes this

11 industry less attractive.

12   JUDGE STRICKLER: Thank you.

13   CHIEF JUDGE BARNETT: Mr. Pakman, I

14 understand, in this struggling company, Pandora,

15 are the executives waiving their pay to make the

16 company appear more attractive, perhaps, or

17 profitable?

18   THE WITNESS: I honestly don't know.

19 BY MR. KLAUS:

20   Q   Just to pick up on the Chief Judge's

21 question, the struggling company, Pandora, you're

22 aware they went public in 2011, correct?

23   A   Yes.

24   Q   They were one -- it was one of the

25 biggest paydays for venture capitalists in all of

6248

1   2011, correct?

2   A   I have not reviewed 2011's returns.

3   Q   Well, are you aware that Labrador

4   Ventures, for example, that's a venture capital

5   firm you've heard of, right?

6   A   I have, yes.

7   Q   They participated in the

8   7.8-million-dollar round of financing and their

9   venture capital investment was worth 141 million

10 bucks on the day of Pandora's IPO. You're aware

11 of that?

12   A   I'm not aware that that was their exact

13 number, but I'll take your word for it.

14   Q   Crosslink Capital, you've heard of them?

15   A   I have.

16   Q   They participated in a 12-million-dollar

17 round of funding. Is it news to you that their

18 stake was worth 382 million dollars on the day of

19 Pandora's IPO?

20   A   I didn't know that was their stake value

21 on the day of the IPO, no.

22   Q   Any reason to doubt it?

23   A   No.

24   Q   Greylock Capital, you've heard of them,

25 right?

1   A   I have, yes.

2   Q   One of their partners is a member of

3 Pandora's Board of Directors, right?

4   A   I didn't know if he still was, but I

5 know at one point he was.

6   Q   Now, to be fair, they also had the good

7 success to invest in LinkedIn that year, but

8 cumulatively, between Pandora and LinkedIn, you're

9 aware that Greylock Capital's holdings were worth

10 more than 1.2 billion dollars as a result of

11 Pandora's IPO?

12   JUDGE STRICKLER: As a result of

13 Pandora's IPO or the combined IPO?

14   MR. KLAUS: The combined IPOs of Pandora

15 and LinkedIn. Thank you, Your Honor.

16 BY MR. KLAUS:

17   Q   You're not aware of that?

18   A   No, I was not.

19   Q   Any reason to doubt that that's the

20 case?

21   A   Thankfully you have the judge here to

22 correct you, so no.

23   Q   Any reason to doubt it's the case as a

24 result of those two?

25   A   No.

6250

1   Q   Okay, thanks.

2   The last question, the opinions that

3   you're expressing here before the judges in this

4   rate setting proceeding about venture capitalists

5   not liking the idea of investment in digital

6   music, this is an opinion you have taken

7   elsewhere, correct? You've stated this in many

8   different places.

9   A   I have. I think my opinion has been

10   consistent over the course of the rates being what

11   they are, yes.

12   Q   And one of the places that you do that

13   is on your blog, right, your disruption blog?

14   A   Yes.

15   Q   Another place you did it was before

16   Chairman Goodlatte's subcommittee in the House in

17   November of 2012, correct?

18   A   Yes.

19   Q   You brought opinions that were very

20   similar to the ones that you're expressing here to

21   that subcommittee, correct?

22   A   Yes, I did.

23   Q   You were testifying in that; that was

24   part of the Internet Radio Fairness Act, correct?

25   A   Yes, it was.

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1   Q   It was trying to encourage Chairman

2   Goodlatte and members of the committee and

3   Congress in general to pass a law that would have

4   changed the standard that applies for rate setting

5   in this proceeding to one that controls in the

6   satellite proceeding, right?

7   A   I was there to provide testimony on my

8   view of whether venture capitalists find Internet

9   radio a fertile area for investment, and I

10   concluded a similar point of view as I've

11   expressed here.

12   MR. KLAUS: No further questions, Your

13   Honors.

14   CHIEF JUDGE BARNETT: Thank you.

15   Anything further?

16   MR. MILLER: Nothing further.

17   CHIEF JUDGE BARNETT: Thank you,

18   Mr. Pakman.   You may be excused.

19   (Witness excused.)

20   CHIEF JUDGE BARNETT: We will be at

21   recess until 9:00 in the morning.

22   MR. POMERANTZ: I'll give you our

23   witnesses.

24   JUDGE STRICKLER: You read my mind.

25   MR. POMERANTZ: So Captain Kass will

1 start, I think, tomorrow morning. Then we have

2 five witnesses who we are trying to finish -- we

3 have to finish by the end of the day Friday

4 because they're not available next week. In order

5 of when we'll call them, Professor Rubinfeld;

6 Mr. Barros, B-A-R-R-O-S, Concord Music; Mr. Kooker

7 from Sony; Professor Lys; and Ms. Butler. If we

8 have any time at the end of the day on Friday

9 after all of those witnesses, Mr. Van Arman will

10 be back as well.

11   JUDGE STRICKLER: Thank you.

12   CHIEF JUDGE BARNETT: Thank you.

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14   (Thereupon, the proceeding was adjourned

15   at 4:17 p.m.)

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 1            CERTIFICATE OF SHORTHAND REPORTER

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 4   Reporter, the court reporter before whom the

 5   foregoing proceedings was taken, do hereby certify

 6   that the foregoing transcript is a true and

 7   correct record of the testimony given; that said

 8   testimony was taken by me stenographically and

 9   thereafter reduced to typewriting under my

10   supervision; and that I am neither counsel for,

11   related to, nor employed by any of the parties to

12   this case and have no interest, financial or

13   otherwise, in its outcome.

14

15            IN WITNESS WHEREOF, I have hereunto set

16   my hand and affixed my notarial seal this 28th day

17   of May, 2015.

18

19   My commission expires June 30, 2017

20

21

22

     _____
23   MICHELE E. EDDY
     NOTARY PUBLIC IN AND FOR
24   THE DISTRICT OF COLUMBIA

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